

INITIATING CHANGE IN TURBULENT TIMES

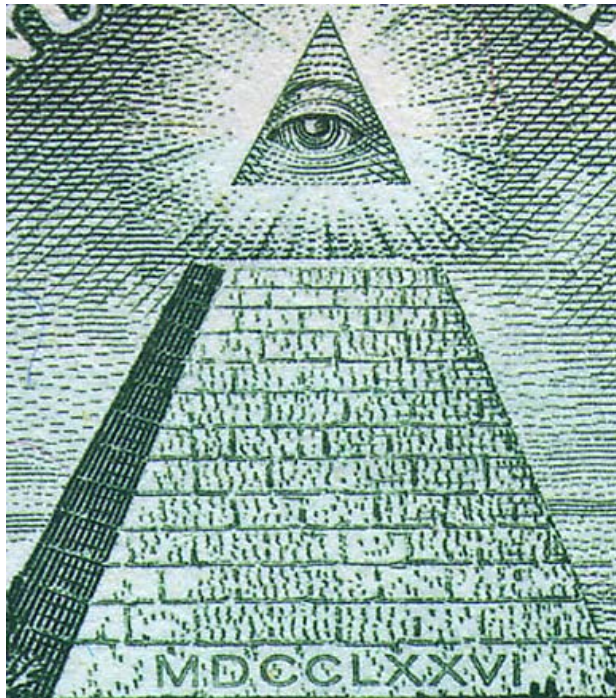
The Role of the Board and the Advisors

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INITIATING CHANGE IN TURBULENT TIMES THE ROLE OF THE BOARD AND THE ADVISORS

WHO REALLY OWNS THE CHANGE PROCESS?

At all times, but especially in times of economic turbulence, the company's Board of Directors and advisors must play key roles in initiating change and overseeing its implementation. And yet, there is always the question as to who really initiates change, who owns the change process, and who will actively oversee its timely implementation. The answer too often has been "no one"!

All advisors to public, private, or not-for-profit enterprises must be willing to challenge management to a much greater degree than in the past. Short of this, little change will occur and the organization will be at risk of becoming marginalized in the marketplace. Warren Buffet is fond of saying, "When the tide goes out we find out who is swimming naked." When the tide went out in this recent economic downturn many were surprised to learn how many directors, advisors, and executives of America's iconic companies were in fact swimming naked, but apparently didn't realize it.

As organizations falter, fail, or get bailed out the same question is always asked: "Where were the Board members and the professional advisors when this was happening?"

To better answer this question, Board members and outside advisors are starting to assume greater responsibility for those factors that create enterprise value. This is occurring within the context of thoughtful and timely corporate governance practices.

WHY CHANGE MUST START WITH THE BOARD

Globalization, technology, new competitive threats, changing consumer behaviors, and restlessness by employees and shareholders have placed new and different responsibilities on today's Boards and advisors.

Directors who showed up at board meetings, rubber stamped the decisions of the CEO, and reviewed budgets or the last quarter's financial results may have been typical in the past. But over time this behavior has not generated superior returns and, in fact, much enterprise value has been destroyed. This fact was clearly illustrated by the recent bailouts, which exposed a shocking lack of board engagement or knowledge of business models, value creation, and risk understanding. And so it is fair to ask: "Where were the Directors?"

Traditionally Directors expected the CEO to initiate change, execute a value creating strategy, manage all levels of risk, build the management team, and report results to the board.

Board members who took some initiative to really understand value creation, business risks and the operating environment, and who actively challenged management, often found their role to be an awkward one. This questioning, challenging, and intellectual role is often in conflict with established Board practices and inconsistent with the expectations of the Board chair or the CEO.

If the Board is not inclined to embrace this enhanced level of governance, or if Board members do not have the kind of experience, qualifications, or expertise necessary to be an effective contributing resource to the enterprise, then new Board members or professional outside

WHY CHANGE MUST START WITH THE BOARD (CONTINUED...)

advisors should be recruited to help the Board carry out its responsibilities to its shareholders and constituencies.

Some of the best practices that Boards and organizations are adopting and implementing as they move away from a passive advisory role to a role that embraces enterprise value creation through best governance practices include the following:

- **Initiating the Corporate Strategy:**

Boards should initiate an in-depth examination of the strategic planning process and determine the ability of the CEO to drive real change as a means to create enterprise value.

As a part of this best practice, Boards must determine the ideal leadership style required to implement the chosen strategy. Unknowingly, Boards tend to view this strategy/execution process backwards—especially when there has been a change in leadership. Too often Boards allow the strategy to be altered to fit the experience and résumé of the new leadership who may know little about the organization, its culture and the competitive environment.

Initiating and executing strategic change of any kind poses a significant communication challenge at any time—and especially during unsettled times. Without strong Board and CEO leadership the marketplace and the organization will become confused, dysfunctional, and skeptical.

Crafting a continuous communication strategy, from the top of the organization to the field to the shareholders and the greater community, and introducing the reasons for change and the outcomes to be achieved, are top priorities for the organization in setting the stage for a change process. Painting a landscape of the company's future is the best place for the Board and CEO to start the communication process.

- **Management and Board Succession:**

Serious and continuous succession planning at the Board level presents an opportunity for the Board to know all the key leaders of the organization.

Best practices dictate that the Board takes a more active role in leadership planning than has been traditional in most organizations. While respecting that the role of the CEO and the management team is important, it is the duty of the Board to lead the succession process to avoid leadership gaps, surprises, or mistakes.

The Board must be able to identify key individuals, within and outside of the firm, who can be called upon as needed—especially during times of management change or economic downturns. Bench strength may be expensive, but it is less costly than recruiting and backing the wrong leader.

The Board succession and self assessment process is a critical responsibility to assure the long-term viability of the organization. The role of the lead Director or the chair of the governance/nominating committee is to be the change agent for the enterprise. The degree of change required is a factor of the present state of the Board's culture, involvement, the operating environment, the changes anticipated in the marketplace, and the capabilities of the Board and the CEO to lead a change process.

- **The Board's Role in Risk Oversight:**

A great deal of criticism has been recently leveled at Boards in the financial services, mortgage, auto, and housing industries for their apparent lack of any real understanding and oversight. This may have been an accepted practice, but passive oversight disguised as fiduciary duty has resulted in tens of billions of dollars in lost market value, often to the surprise of the directors and outside advisors. Shareholders have every right to ask: "Where was the Board?"

INITIATING STRATEGIC CHANGE

A business downturn or change in the competitive marketplace, while rarely celebrated, often represents a timely opportunity for the Board of Directors to engage management on the organization's present business model and strategic planning process.

Because beliefs and behaviors within the organization are almost always set against change, the change process is difficult to implement in good times and nearly impossible in downturns.

The typical organizational response in times of uncertainty is most often tactical—to shrink, sell assets, pay down debt, and reduce headcount. Thinking about true differentiated strategic change is atypical, even though experience indicates that more value creating opportunities are available during unfavorable market or industry conditions.

At all times, but especially in times of economic change, the key initiators of the enterprise change process should be the members of the company's Board of Directors, driven by the lead independent Director in concert with the CEO and the organization's outside advisors.

Most senior managers imagine that as "soon as the recession is over" the organization will be back on course. This degree of optimism, while welcome in CEOs and admired by the organization, is frequently the reason that real strategic change does not take place.

An understanding that there is no "back to normal" must start with the Board and be supported by the company's outside advisors. Short of Board leadership, the CEO will do little except cut costs to minimize any near-term losses.

Curiously, many CEOs believe that this is what the Board and the shareholders want them to do, and in the absence of a clear Board mandate

this is what will happen. Look no further than the auto, financial services, and housing industries to learn how well this "return to normal" approach has fared. Incremental change is never sufficient to create sustainable enterprise value.

There are several ways the organization can start to implement value creating strategies. A timely starting place is for the Board, in concert with management, to develop a short-term tactical plan that positions the company for change and, concurrently or shortly thereafter, to develop and commence execution of a strategic change planning process.

Offensive "what if" planning is not just an interesting tactical exercise to undertake in a slow down, it is a necessity at all times. Few Boards engage in the process and, to the extent they do, their efforts tend to be one-dimensional.

Unfortunately, outside advisors rarely have any serious discussions with their clients about offensive change planning. Yet this is a role in which they can be a resource because they often have a long relationship with the company as well as the additional benefit of sharing the experiences of other clients.

Starting a conversation on the issue of change is more timely than ever, particularly with attorneys, accountants, wealth managers, and consultants.

The challenge for leadership is to successfully execute and communicate a tactical planning process for today while, at the same time, implementing a long-term plan based on an understanding of the future. Enterprise value does not increase as a function of time, experience, or years in business. Time does not create value, change does.

INITIATING STRATEGIC CHANGE (CONTINUED...)

The degree of Board control and oversight in both strategic and tactical planning will be a function of present circumstances, the operating environment, and management's historic level of success in planning and achieving timely corporate goals and budgets. Managements unable to achieve targeted outcomes on a regular basis may need Board assistance because the organization's planning process is flawed or their ability to execute is limited.

THE BOARD'S ROLE IN SUCCESSION PLANNING

There are several reasons why the role of Directors and outside advisors is changing in good times as well as in times of turbulence, but perhaps none is more visible than turnover and the shorter tenures of CEOs and senior executives. For the first time since data has been collected the length of service of many key executives, especially the CEO, has become significantly shorter. According to the international executive search firm, Egon Zehnder, the average tenure for a CEO declined from eight to four years from 2003 to 2007.

And, since 2007, more than a third of CEOs have been in their position for less than three years. Shortened tenure is also occurring in other key areas throughout organizations, especially in marketing, finance, and technology.

Not surprisingly, Board self-assessment surveys continue to indicate that the management succession topic is among the least effective of all the areas of oversight. Yet little constructive action is taken beyond acknowledging this concern. Boards must want to change. Unless the lead independent Director wants change to occur, no action by shareholders or other constituencies will make any difference in Board behavior or effectiveness.

In many organizations the Directors and some outside advisors are by far the longest serving members of the organization, and with that tenure comes more and different responsibilities.

But, while all Board members readily agree to the importance of the succession function, there is frequently a level of confusion as to who really owns which process, and who is supposed to do what.

Past practices find that many Boards delegate this responsibility to the CEO and his team. But there is widespread agreement that this is effective neither in good times nor during periods of economic or industry uncertainty.

THE BOARD'S ROLE IN PLANNING AND RISK OVERSIGHT

The Board, in concert with outside advisors, the CEO, COO, and the CFO, should initiate and drive a discussion on resource allocation and risk—even if a reluctant CEO and CFO view this area as their turf. This kind of oversight goes far beyond approving the capital expenditures budget. Serious long-term resource planning includes both qualitative and quantitative considerations.

Some of the areas which require more Board oversight include the following:

- What is the target ROI and free cash flow the company must generate to create enterprise value? How can the company re-configure financial performance to that benchmark? The Board needs to be shown by management how superior returns can be generated, and be satisfied that risk can be controlled.
- What is the maximum amount of leverage the company can manage and what are the risk factors to be quantified?
- What is the firm's expressed or implied growth plan and growth strategy? It's critical to determine what growth is good and what growth is not.

SUMMARY

The rapidly changing landscape for all organizations is the key reason the Board of Directors will want to take effective control of the strategic change planning process. Periods of economic or industry slowdowns can represent an opportune time for the Board to test management's ability to plan and execute a differentiated strategy for change that results in value creation for the enterprise.

Deferring to the CEO, especially a new one, to develop a new strategy or better execute the established strategy generally fails to produce results in a timely fashion. This is an often-repeated mistake because historically Directors have not taken ownership of the strategy process, do not know the business, the industry, or the external environment well, and are not familiar with the talent pool's ability to execute. The Board punts to a new CEO with a résumé to develop the plan and they bless it because they imagined their role was simply to hire a new CEO who would both develop and execute a new business plan. The landscape is littered with firms whose shareholder value has been destroyed by passive Director engagement. A short list includes AIG, Merrill Lynch, General Motors, Enron, and Citicorp.

While past commercial success may have occurred without the active involvement of the Board, that past success may have little bearing on what change is required to be successful in the future. The Board and the management team must work and act together, but the board must lead the process of establishing corporate change objectives and setting the strategy.

In order for any change process to succeed, the Board's role must be redefined from essentially passive and fiduciary to active, challenging, and fiduciary. Strong Board leadership is necessary to effect meaningful organizational and strategic change—never more so than in turbulent economic times.

The increasing complexity of leading business change in all times, but especially in times of an economic downturn, places a significantly higher level of risk oversight on the Board. They must fully understand the landscape, the business model and its risks, and not accept the optimistic commentary of the CEO.

The role and responsibilities of the formal or informal advisory Board and the role of the outside advisor is changing unalterably. Past governance practices are insufficient to create enterprise value. Regaining trust from customers, suppliers, employees, and shareholders has never been more important. Redefining the role of the Board as a change agent in the creation of sustainable enterprise value requires a new contract with CEO's and the management team. The interest of all constituencies must be served, resulting in the need for a new breed of Director and a different kind of professional advisor.

While the Board has the legal authority, outside advisors have a unique challenge because they have no real authority or influence except that given to them by their clients.

If advisors are to earn trusted, relevant positions of influence their behavior must change. Rather than serving as vendors of products or services (loans, audit reports, legal documents, or quarterly investment reports), true advisors must seek to understand client needs, the business landscape, and opportunities to create enterprise value.

Short of that the outside advisor will remain a vendor with no meaningful advisory role and little influence on the success of their client.

ABOUT THE BIGELOW COMPANY

Originally established in 1935, The Bigelow Company focuses exclusively on working with the most successful owner-managed companies in North America. Bigelow provides objective advice to its clients on matters of business strategy and ownership succession, leading to the successful outcomes of value creation, and someday, capturing the value they have worked so passionately to build.

As we look together at the current landscape of uncertainty, perhaps only a few things are clear: once-successful behavior patterns will not be sufficient to survive, let alone flourish in uncertain future economic scenarios. Embracing change as a means to create increased Enterprise Value for all stakeholders is always important, but critical in times of uncertainty and turbulence. Bringing about that change in entrepreneurial organizations, where ownership and management control is frequently concentrated, can be daunting for advisors who are inexperienced in that domain.

Senior members of the Bigelow team have been active participants in successfully leading the governance of private and public, for-profit and social sector enterprises in dozens of industries over multiple business cycles. Clients tell us that this transferable “scar tissue” has provided them with invaluable insight on behaviors and strategies that drive one enterprise to earn superior returns and premium Enterprise Value, and another to fail.

Bigelow has developed sophisticated proprietary tools that are based upon the artful query of entrepreneurs. These tools illuminate ways for CEO’s, Boards, and other expert advisors to systematically understand the trusted leadership and the techniques needed for allocation of resources that drive successful change within entrepreneurial cultures.

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