# TURNING AROUND THE TECH TURNAROUND

By Jody Foldesy, Derek Kennedy, Kyle Braden, Simon Bamberger, and Hady Farag

THE ONGOING SUCCESS OF the so-called FAANG stocks masks the reality that the financial performance of many tech companies has stalled. Despite their stumble at the end of 2018, Facebook, Amazon, Apple, Netflix, and Google's parent, Alphabet, have been leading the overall equity markets for years. Meanwhile, many of their peers are growing modestly, facing complexity, and feeling pressure to perform.

These companies may not be at risk of imminent failure, but many have not fortified their business models, scrutinized their cost structures, rigorously reviewed operations for new sources of growth, or refined organization processes. In short, they need to reinvent themselves. And if they don't take the initiative soon, activist investors may do it for them.

A tech turnaround is not the same as the classical, across-the-board, cost-focused program that many tech companies executed amid financial distress. That blunt instrument can help create breathing room, but rarely does it change the strategic trajectory of a company, create excitement among employees, or reshape the company to win in the future.

The tech industry is ripe for a specific type of intervention: a tech turnaround. Many tech companies are facing one or more of the following conditions:

- Relative underperformance
- Low or negative margins
- Overreliance on a single product or a legacy business model

While these conditions might not normally demand that a company undergo a traditional restructuring, they do suggest that it has work to do to improve performance. Turnarounds built on performance, not just costs, create opportunity and possibility *and* attack inefficiencies and waste. Tech turnarounds also address behavior and capabilities so that the organization ends up stronger and more resilient than before. They reallocate financial and human resources to capitalize on the greatest opportunities.

For tech companies, the saying that "you can't cut your way to growth" has never been truer. It's time to resume growth through a tech turnaround.

## The Great Moderation

Over the short term, many factors drive TSR in the tech industry, including margin, changes in multiples, and cash payouts to shareholders. Longer term, growth is what creates the most value for top-quartile performers.

Not all growth, however, creates value. Tech companies can grow rapidly and still generate low shareholder returns if they do not focus on margins, multiples, dividends, and share buybacks. A tech turnaround delivers both long- and short-term shareholder returns. (See Exhibit 1.)

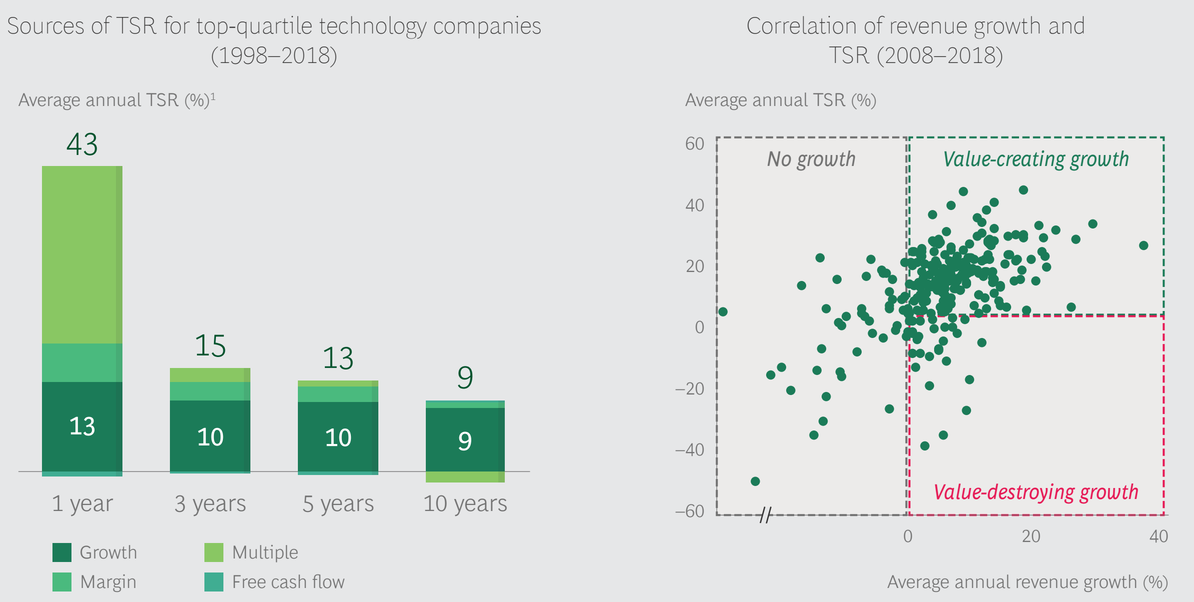
The high-flying tech stocks will continue to rely on growth for long-term value creation, but for every tech company that achieves double-digit growth annually, another is barely growing at all. Between the two extremes, much of the industry has ratcheted down to single-digit organic growth, more in the line of sight of high-end-value or growth-at-a-reasonable-price investors.

These companies have started to rely on a different playbook. (See the sidebar "Restoring an Old Startup's Magic.") For example, the share of dividend-paying US tech companies and their average payout ratio have doubled since early this decade.

This shift to a more balanced TSR strategy has profound implications for tech companies:

- The search for performance levers beyond growth, especially cash generation management, requires a significant shift in resource allocation, management attention, and capabilities.
- With many tech stocks still fully valued and growth harder to come by, future returns must come from disciplined capital allocation and balance sheet management.
- Executives must prepare for new levels of investor scrutiny of operational

Exhibit 1 | Growth Fuels Long-Term Value Creation, but Not All Growth Is Good Growth




**Sources:** S&P Capital IQ; BCG ValueScience Center; BCG analysis.
[1]Annualized TSR based on rolling periods of one, three, five, and ten years from 1998 through 2018.

## RESTORING AN OLD STARTUP'S MAGIC

A tech company, nearly 20 years old, agreed to a multibillion-dollar acquisition that likely would never have happened—and certainly not at such a price—if it had not first undertaken a successful turnaround to improve performance.

This company—let's call it SampleCo—had been in business longer than its main competitors, but its business model was out of step with the market. By the time that SampleCo had shifted its model, it was fighting off activist investors and losing customers, money, and momentum. A tech turnaround helped the company deal with these challenges and eventually find a friendly purchaser. In the two quarters prior to the announcement of its acquisition, SampleCo got its groove back, twice exceeding Wall Street's growth expectations and more than doubling its share price.

How did SampleCo achieve a second act? In short, it followed a tested three-step playbook that works for traditional and digital companies alike.

**Funding the Journey.** Organizations undergoing a turnaround need both to demonstrate quick wins and to free up cash to invest in long-term ambitions. To this end, SampleCo first flattened the organization and eliminated duplication of roles and responsibilities. The restructuring freed up considerable cash flow and made the company nimbler and more responsive in its decision-making processes, clarifying who to go to, for what, and when. Second, it started to move key jobs from its headquarters to a city that is rich in engineering talent and offers the lifestyle pluses of Silicon Valley for much less money than, say, Cupertino or Sunnyvale.

**Winning in the Medium Term.** In general, a successful turnaround produces a new business model—in many cases, within one to three years. SampleCo was well on its way to creating a subscription business that complements its traditional business and tightening its bond with subscribers through improved digital marketing and stronger customer retention and engagement strategies. In addition, SampleCo had started plowing its cost savings into new technologies and revamping its sales activities through segmentation, automation, and the development of an inside sales team. For the longer term, the company was set up to expand into new markets.

**Organizing for Sustained Performance.** Turnarounds cannot be just about revenues and costs. The best-run turnaround will ultimately fall flat if it lacks the right organization, culture, and talent to drive and sustain change. Many of SampleCo's transformational moves were specifically aimed at creating long-term success. The delayering, for example, removed duplication and frustration. The move to a different city allowed the company to tap into an alternative pool of engineering talent. Although SampleCo still faced challenges, it was on much stronger footing for a cultural and business refresh.

effectiveness and must be willing to lead major cross-divisional initiatives on productivity—not just costs.

- CEOs and CFOs must be comfortable and credible discussing these topics with investors.

## Motivating a Tech Turnaround

Periods of slow growth, low profits, and relative underperformance provide perfect opportunities for a company's leaders to step back from the day-to-day business, evaluate the company's outlook, and seek ways to reshape value creation.

This kind of review can illuminate opportunities for taking bold steps—opportunities that would not arise during routine, business-as-usual activities. It can also rally the leadership team and broader organization around a common, critical goal and drive tremendous value.

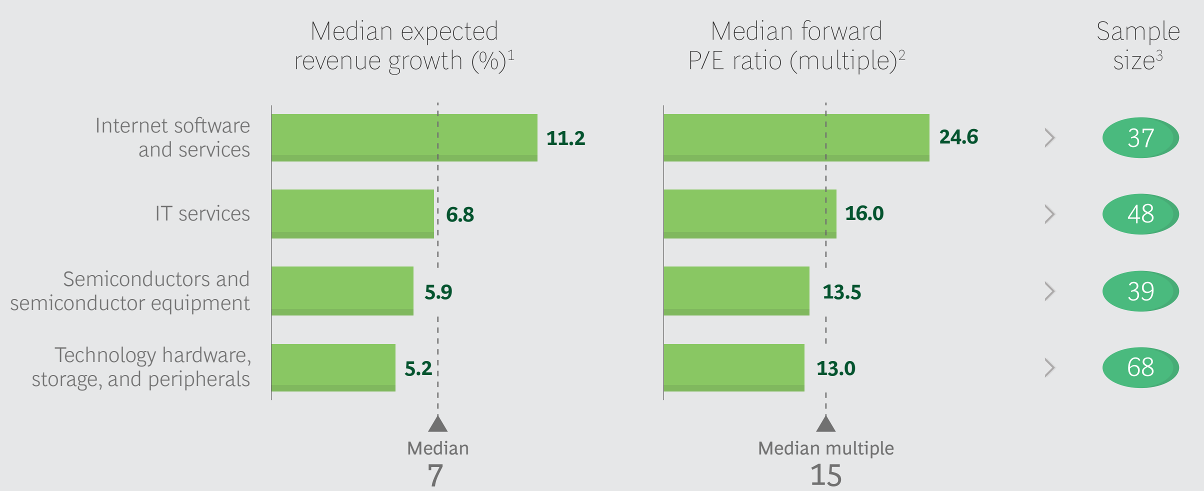
This should not be a cookie-cutter exercise. Technology companies are not all the same. A company's business model and environment, for example, influence growth momentum and investor expectations. Internet and software companies are growing—and are expected to grow—the fastest. It is no surprise that these companies also tend to attract the highest valuation multiples. (See Exhibit 2.) This creates the danger of a sharp decline if growth slows. Tech companies whose core markets are persistently eroded by competition might find that their stock prices move little from year to year or even over the course of a decade. This in turn has profound implications for employee morale and the ability to use equity as currency to attract high-performing talent. Meanwhile, companies in hard-hit sectors may outperform because expectations are so low.

Ideally, a company can launch a turnaround on its own terms and have full control over timing, focus, and results. But sometimes, a catalytic event forces leaders' hands. While this can create uncertainty and promote employee turnover, it also generates a sense of urgency and clarity among senior leadership. Such events include the following:

- Activist shareholders taking a stake in the company
- The appointment of a new CEO or new board members
- A fundamental disruption of the company's business or industry
- A major transaction, such as a significant M&A deal

Although such events can come as surprises, many can be anticipated if a company engages in strategic analysis and foresight. Even the arrival of activist investors is generally predictable. Leaders can determine the likelihood of such events and prepare to take preventive action. (See the sidebar "How to Know When an Activist Might Strike.") But even in the absence of an existential threat, companies should cultivate a similar sense of urgency toward a turnaround.

EXHIBIT 2 | Technology Companies Differ Greatly in Terms of Growth Momentum and Investor Expectations




**Sources:** S&P Capital IQ; BCG ValueScience Center; BCG analysis.
[1]Two-year consensus revenue growth estimates, excluding outliers that were more than 50% above or below the median.
[2]Forward multiples as of December 31, 2018, excluding outliers with multiples that were greater than 50 or less than 0.
[3]Sample of US-based information technology companies whose revenues and market capitalization were at least $500 million as of December 31, 2018.

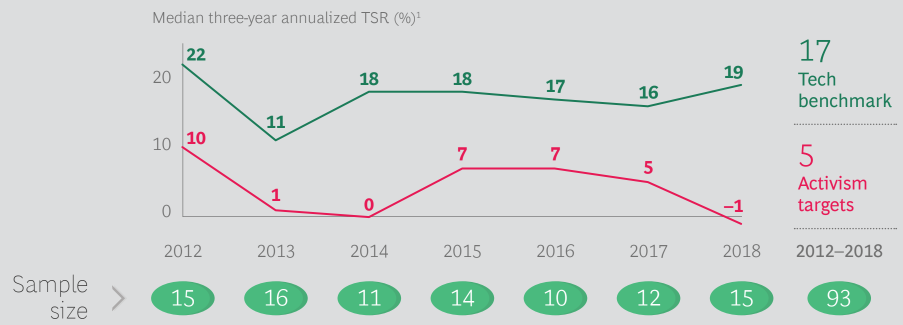
## HOW TO KNOW WHEN AN ACTIVIST MIGHT STRIKE

It's not a secret that activist shareholders target tech companies. To date, 2018 was the busiest year for activism—overall and in the tech industry. Of technology businesses, software companies have been the most vulnerable. Over the past four years, software companies drew nearly half of all activist campaigns in tech. But other technology businesses are far from immune, and their leaders must ask themselves, How can we determine whether we are at risk?

Activists, it turns out, are predictable in their pursuit of targets. These investors zero in on companies with lagging shareholder returns, multiples, and margins. But the landscape is becoming more perilous for all technology companies. On average, the targets of activists in the tech industry delivered three-year annualized TSR of 5% in 2017. (See the exhibit below.) But many of them did far better.

In other words, adequate shareholder returns are not good enough to protect tech companies from activism. Companies that underperform peers by even a few percentage points could be vulnerable to attack. By actively shaping their futures, leaders can reward shareholders and avoid having to play defense or settle with activists.

### Activist Investors Attack Underperforming US Tech Companies




**Sources:** Activist Insight; S&P Capital IQ; BCG ValueScience Center; BCG analysis.
**Note:** Sample size includes US tech companies whose market capitalization was at least $500 million and that were subject to an activist event.
[1]TSRs are for the three years prior to the activist event.

## Five Imperatives of a Tech Turnaround

Tech turnarounds are unlike traditional cost-out transformations, which, in many cases, are simply alternatives to bankruptcy protection to stave off insolvency. Instead, tech turnarounds seek growth, margin improvement, and the opportunity to reinvigorate employees. There are five critical aspects to a successful turnaround.

The whole company is in play. A company cannot fully turn around unless its leaders are willing to reexamine the entire organization. If a company works on fixing only the easy stuff or limits its attentions to specific businesses or functions, it will miss the big-ticket opportunities. Costs remain an element in these transformations but should not be the sole focus.

Executives can often find value in hidden or protected corners of their organization or by looking across the organization rather than down vertical silos. On the cost side, many companies can save money by, for example, consolidating offices even if that means combining different businesses or functions in the same location. On the growth side, a focus on customer journeys can generate both revenues and loyalty if all the relevant parts of the business are aligned.

This comprehensive approach borrows a page from the typical activist playbook. These investors are known to leave no stone unturned in their initial analysis. They commonly announce themselves to target companies through a letter that outlines a broad series of potential changes. Rather than wait for this to happen, company leaders should themselves conduct this do-it-yourself-activism exercise as an eye opener. If they take the task seriously and avoid becoming defensive, leaders will likely discover hard truths about their business that had been obscured by everyday demands.

The turnaround agenda is the company's agenda. A turnaround is not an adjunct to the company's business or something that is slotted into the calendars of busy executives in rare periods of downtime. For the duration of the turnaround, it must be the primary responsibility of the senior leadership team.

A successful tech turnaround functions as the centerpiece of several intertwined initiatives to improve performance and shift strategy. It should not be just another effort running in parallel with major initiatives already coming out of the strategic plan. All initiatives should be coordinated and managed centrally, overseen by the chief transformation officer or a person with a similar set of responsibilities. The leadership team should engage in hands-on working sessions at least every other week.

The turnaround should be a galvanizing moment. A successful tech turnaround helps create transparency and a common set of facts that focus the leadership team on collectively transforming the company. Rather than having each leader examine his or her budget to find 5% or 10% in savings, company leaders must work together on cross-cutting initiatives such as organization redesign, role clarification, simplification, and the establishment of smart policies on procurement and the use of contractors. The common language and logic created during these turnarounds build organizational "muscle"—efficiency and discipline that last long after the completion of the turnaround.

It takes a program, but it's not a PMO. A traditional transformation is run through a project management office that establishes and tracks targets, deadlines, and metrics. This time-honored approach is, in many cases, too static for a tech turnaround to achieve success. These turnarounds, of course, have goals and ambitions, but they also need mechanisms to enable rapid course correction, revisiting of targets, and the pursuit of fresh opportunities that emerge during the course of the transformation. Many plans are outdated almost as soon as they are written, so companies should operate a test-and-learn, iterate-and-revise agile approach.

The ultimate goal is profitable growth. Tech companies have to understand how to generate growth that also creates value. Most often, this is growth that protects or even improves margins and does not drain the company's cash coffers through, for example, expensive acquisitions.

In their pursuit of profitable growth, companies should explore a range of options, such as expanding into adjacent opportunities, creating recurring as-a-service revenue streams, and revamping sales coverage. They should also aim to improve efficiency and returns on investment by pruning low-margin products from their portfolios and investing the savings into more profitable products.

Of course, cutting costs will likely be a plank in any turnaround. But cost reductions should focus on making the company's cost base more competitive and scalable, especially if the company is still growing in the high single—or even double—digits. Without fundamental process, organization, and systems redesign, costs are likely to "grow back," often in ways that are less efficient than the starting structure.

## Get Moving

Turnarounds geared toward performance are built to last. They position companies for the future through laser-like focus on value creation, skills and capabilities, engagement, and execution. By initiating turnarounds preemptively, a company can control its destiny rather than be whipsawed by external events and actors.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