Declining Companies

2015

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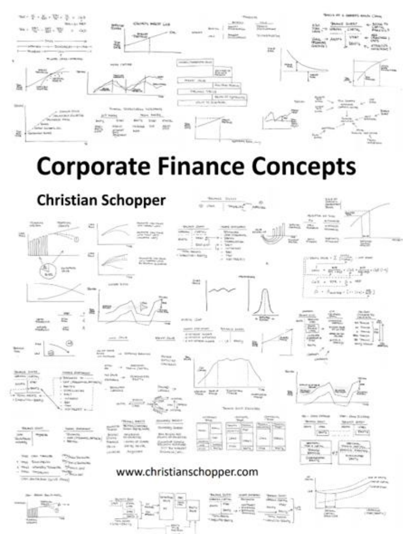

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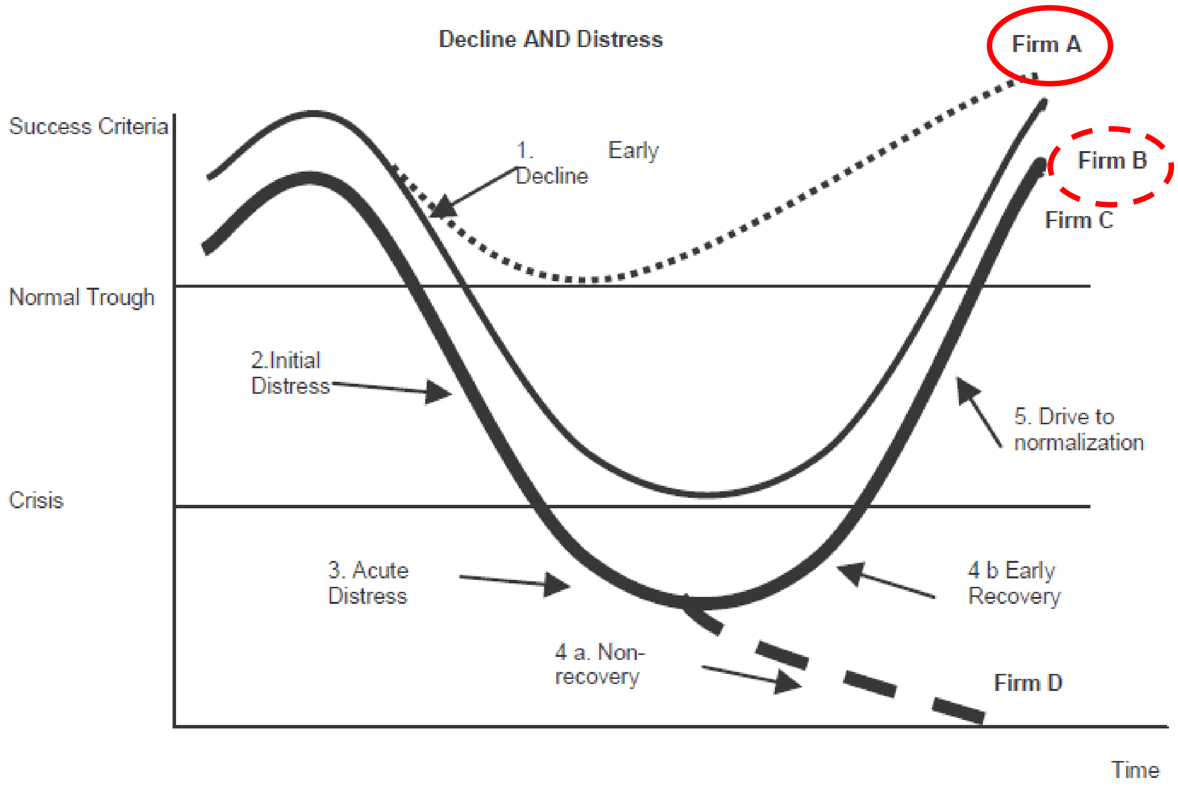
Decline vs Distress



Decline vs Distress (cont´d)

		Distress	
		Yes	No
Decline	Yes	• Cyclical decline in industry or market leading to higher financial and operating (systematic) risk	• Normal business cycle variation • Difficult to distinguish a normal downturn from a problematic one requiring restructuring
	No	• Profitable firm growing beyond sustainable growth rate leading to bankruptcy because of cash-flow problems	Healthy Company

The Big Shift

	Experiment	Scale	Mature	Decline
Objective	• Validate opportunity	• Scale business model	• Produce cash	• Release cash from un-profitable operations
What motivates managers?	• Passion for idea • Fun and excitement • Recognition	• Share of upside • Satisfaction of building something	• Security of working in established business • Autonomy • Power	• Pay and bonuses for making tough decisions
Who are the best managers?	• Scientists and inventors • Opportunists	• Experienced builders with clarity of focus and drive to execute	• Active stewards who are adept at spotting and neutralizing threats to core	• Turnaround artists who are relentless in instill-ing financial discipline
Which metrics measure progress?	• Milestones marking specific achievements (often measuring customer adoption)	• Focus on growth and time to profitability	• Numerous metrics, typically refined and financial, often extrap-olated from the past	• Measures of cash released from terminating money-losing activities
How to secure or release resources?	• Spread passion for opportunity • Bootstrap • Limit resources required	• Build enthusiasm with exciting growth story • Generate fast profits to protect business from skeptics	• Generate cash to fund growth elsewhere • Protect the core busi-ness from any threats	• Prune resources from declining businesses to fund growth elsewhere
Predictability (1 low to 10 high)	1 to 3	4 to 6	6 to 8	8 to 9
Financial institutions that specialize	• Angel funding • Incubators • Early-stage venture capital	• Venture capital	• Banks • Public equity markets	• Leveraged buyout firms

Introduction

- **Low business risk** should be complemented by a relatively **high financial risk** source
- The yields of a **reinvestment** strategy in a dying business is likely to be **low**, because the future **growth prospects** are now **negative**
  - Dividends can exceed profits due inadequate financial justification to reinvest depreciation
  - Hence, dividends may equal the total of profits and depreciation
- Equity **investors** will still **require a risk-adjusted return** on this investment
  - However, some of these equity funds to be released by the company prior to its liquidation
- Lenders should be willing to **lend against** the ultimate **realizable value of the assets**
  - These borrowings can be paid to shareholders by way of dividend or share repurchase, and again clearly represent a repayment of capital
- The negative growth prospects are translated into a **low P/E multiple** for the shares and, when allied with the declining trend in earnings per share (eps)

Declining businesses	
Business risk	Low
Financial risk	High
Source of funding	Debt
Dividend policy	Total payout ratio
Future growth prospects	Negative
Price/earnings multiple	Low
Current profitability, that is, eps	Low and declining
Share price	Declining and increasing in volatility

General Characteristics of Declining Companies

- Stagnant or declining revenues
  - Inability to increase revenues over extended periods, even when times are good
  - Flat revenues or revenues that grow at less than the inflation rate
  - Overall sector weakness eliminates the explanation "due to poor management …"
- Shrinking or negative margins
  - Losing pricing power
  - Dropping prices to keep revenues from falling further
  - Occasional spurts in profits generated by asset sales or one time profits
- Asset divestitures
  - Existing assets are sometimes worth more to others putting them to different and better uses
  - If substantial debt obligations, the need to divest will become stronger, driven by the desire to avoid default or to pay down debt
- Big payouts – dividends and stock buybacks
  - … if the firm does not have enough debt for distress to be a concern
- Financial leverage – the downside
  - Frequently debt burdens that are overwhelming, acquired when the firm was healthier
  - May face additional trouble in refinancing the debt, since lenders will demand more stringent terms

Typical Balance Sheet Structure

Assets			Liabilities	
Existing Investments Generate cashflows today	Investments already made	*All of the value comes from existing assets, but some of these asset may be woth more liquidiated.*	Debt	*if the firm has high debt, there is the possibility of distress*
Expected Value that will be created by future investments	Investments yet to be made	*Little or no value from growth. Can even be negative, if firm pursues bad investments*	Equity	

- If mature companies get the bulk of their value from existing assets and less from growth assets, declining companies get none (or close to none) of their value from growth assets

- On the liability side, declining firms face much more dire consequences from being over levered, since they cannot count on higher earnings in the future to cover debt obligation. In other words, decline and distress often go hand in hand.

The Final Financial Strategy

- The major risk associated with a declining business is that sudden small changes in the business environment can make the business uneconomic, forcing closure
  - If major costs are still of a fixed or if new expenditures have been justified over a long future period of, the financial impact of such a sudden forced closure can be extremely adverse
- The company can effectively hedge itself from some of these adverse consequences by **focusing on short-term financial impacts**
  - Such is achieved by **using financial payback** as a means of justifying expenditures **rather than** the more sophisticated **discounted cash flow** techniques
- If an **increased cash balance is not required** by the business, it should be paid out to shareholders as reinvestment is often below shareholders ’ required rate of return
  - High dividend payout ratio which will often exceed 100; are actually repayments of capital
- **Shareholders should <u>not</u> be concerned with a declining share price** – as long as they are being **compensated** with a sufficiently **high dividend yield**
- A mature business can add value through **borrowings** because the **positive** the **impact of** the **tax shield** normally outweighs the much smaller adverse consequences of potential financial distress
  - However, the declining business may be thought less likely to pay corporation taxes due to its reducing profit streams, so that the value of the tax shield may be reduced

Adding Value by Borrowing in a Decling Company

- The terminal value of a particular asset is £100,000 …
- … and the company is expected to continue operating for another 5 years

- The shareholders ' after-tax expected return on equity is 10% per annum …
- … but the company can borrow at an after-tax rate of 6% per annum

- The present value to the shareholders of the expected terminal value of the asset is

$$\frac{£100,000}{(1.10)^5} \quad \text{or} \quad £62,092$$

- However, if the company borrowed funds against this terminal value at 6% …
- … it could obtain £74,726 now, …
- … which could be distributed to its shareholders
  – In practice, the lender would want to maintain some buffer to allow for fluctuations in the actual terminal value or date of realization: but there is still an opportunity for significant shareholder value creation

Alternative Business Strategies to Delay or Avoid Death

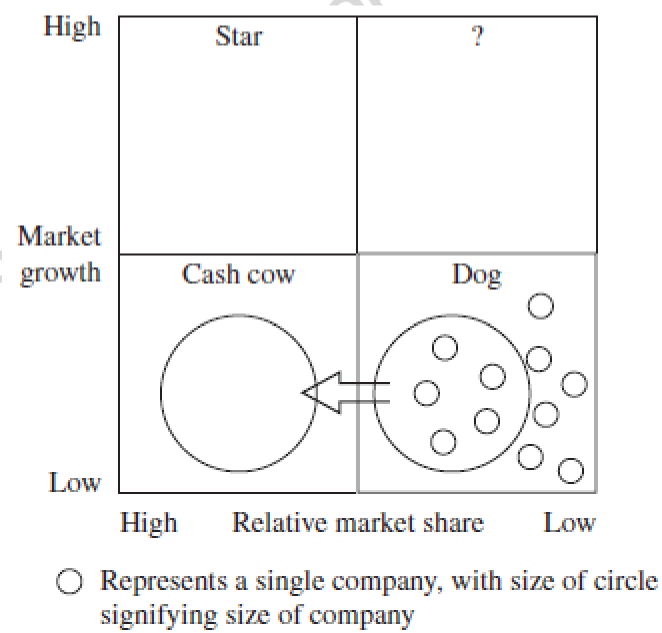
- The final phase of the life cycle represents one of the most **severe challenges** to the concept of **agency theory**, because it may appear essential to many managers that ways must be found to avoid the final act of winding up the company
  - … even though continuing may not be in the best interests of shareholders

- One obvious strategy is to **diversify** into other areas
  - **But**, if the diversification is left until the core business has moved into its decline stage, it will be very **difficult** for the company **to finance** the diversification from a declining cash flow

- A possible way of adding value to the business may be the **aim to achieve a** much more **dominant market share**
  - This could be done simply by **rationalizing** the **total capacity** of their group so as to remove capacity from the industry, if this is depressing selling prices
  - Alternatively the greater market share can be used to change the dynamics of the relative bargaining power with both customers and suppliers; thus increasing the share of the value chain

Financing Alternatives

- Any attempt to rationalize a very mature or declining industry by a series of **acquisitions requires finance** to be raised
- A logical alternative would be to raise at least some **debt**, since debt financing is attractive at this latter end of the life cycle
- **Alternative** is usually a **deep(er) discount rights issue**



Deep Discount Rights Issue

Death Or Glory plc wants to raise some new equity funding in order to repay some of its existing debt financing

- 500 million issued shares trading at £1 each, a market capitalization of £500 million
- Existing debt level of £1 billion …
- … giving a debt to market equity of 2:1 which is considered too high

- if £250 million of new equity could be raised, this debt to equity could be reduced to 1:1 as long as the new funding was used to repay some of the outstanding debt

- The company's advisers have suggested a rights issue of 2:1 at 25p per share which would raise £250 million, excluding costs

500 million issued shares at £1	⇒	£500 million market capitalization
1,000 million new shares at 25 p	⇒	£250 million rights issue
1,500 million total shares ⇒ 50 p	⇐	£750 million new capitalization

- The rights value would be 25p per share (exercise price of 25 p compared to market price at 50 p), …
- … so that the gain of 25p * 2 rights = 50 p compensates for the loss on each existing share of 100p - 50p = 50p
  - The 2:1 rights issue results in no gain and no loss if the share price responds properly

Deep Discount Rights Issue (cont´d)

- If the market believes that successful growth companies raise new equity through narrow discount rights issues, it tends to accept that a company offering a narrow discount rights issue is successful and has good growth potential

- Conversely, if **deep discount rights issues** are normally made by very **mature** or **declining companies** with negative growth prospects, the market may assume that any company making such an issue must have those attributes

- A **benefit** of a deep discount rights issue is that the significant discount at which the new securities are being offered **reduces** the **risk** that the underwriters will be unable **to sell the new stock** to existing shareholders or new investors
  - This reduced risk improves the ability to execute an underwritten deep discount rights issue and reduces the associated underwriting fees to the benefit of the issuer and its investors

- Historically issuers used to avoid executing deep discount rights issue due to concerns that it was a sign of weakness on behalf of the companies concerned
  - These concerns have somehow dissipated in recent years as commentators have recognised that deep discounted rights issues are generally more **cost effective** for the issuers given the reduced underwriting risk

Reducing Risk Perception and Adding Value

- Death Or Glory plc currently has to pay a premium interest rate of 10% before tax …
- … - compared to the normal rate for similar companies of 8% -…
- … due to its high debt to equity ratio

- DOG´s shareholders ’ required return is higher, with cost of equity capital at 16% …
- … compared to 12% demanded from similar companies with normal leverage ratios

	£millions
Operating profit	250
Less: interest expense	100 (£1 billion at 10%)
Profit before tax	150
Taxation	50
Profit after tax	100
Number of shares	500 million
Earnings per share	20 pence
P/E multiple	5 times
Share price	100 pence

- A P/E multiple of 5 is applied, as this is slightly below the inverse of the company’s cost of equity capital (16%)
- This reflects the fact that (a) the company is declining rather than at steady state and (b) there is a risk premium due to the over-gearing

Reducing Risk Perception and Adding Value (cont´d)

If DOG raises £250 million through a rights issue it will be able to reduce both its borrowing cost and its cost of equity

- However, the relative proportion of equity in its financial structure will rise, …
- … as the new funds are used to repay some of the existing debt

	£millions
Operating profit	250.0
Less: interest expense	60.0 (£750 million at 8%)
Profit before tax	190.0
Taxation	63.3
Profit after tax	126.7
Number of shares	1,500 million (1 billion new share issued)
Earnings per share	8.45 pence
P/E multiple	6.7 times
Share price	56.6 pence

- The company's cost of equity has decreased to 12% due to the lower perceived risk
- However, as a declining company, the P/E will still be lower than the inverse of the cost of equity
- Previously, the 'steady state' P/E of 6.25 was reduced by 20% to arrive at 5; …
- … here the 'steady state' P/E of 8.3 is reduced by a similar proportion, to 6.7
  - In practice, the P/E may be slightly higher than this, reflecting a rerating by the market

Summary

- No further investment should be made in declining businesses, so the cash flows will be neutral or positive
  - The low business risk means that funding should be through debt. Dividend payout should be the maximum possible, constrained only by the availability of retained profits or cash generation

- If the company has taken on too much debt, value can be created by reducing the level of gearing

Appendix

Proposal for Valuation Approach

	No or low Distress (Not much debt, investment grade rating)	High Distress (High debt commitments, low rating)
Irreversible (Sector in trouble)	1. Value the firm with existing management and expected decline (Going concern value) 2. Value the firm, assuming orderly liquidation of all of its assets. 3. Expected Value = Maximum (Going concern value, Orderly liquidation value)	1. Start with the expected value (irreversible, no distress) 2. Estimate the probability of distress and proceeds from forced liquidation of firm. 3. Re-compute the expected value, adjusting for distress.
Reversible (Firm outlier n healthy sector)	a. Value the firm with existing management and expected decline. b. Value the firm with better management and recovery. c. Expected Value = Status Quo Value (Probability of no management change) + Optimum Value (Probability of management change)	1. Start with the expected value (reversible, no distress) 2. Estimate the probability of distress and proceeds from distress sale of firm. 3. Re-compute the expected value, adjusting for distress. 4. If equity investors run the firm, value the option to liquidate.

Source: Damodaran, 2009

Excursion: Stabilisation and Decline Strategies

Stabilisation and Decline Strategies

- Stabilisation strategy
  - Normalisation strategy (status quo)
  - Consolidation strategy (increasing effectiveness)

- Decline strategy
  - Retrenchment strategy
  - Turnaround strategy
  - Divestment strategy
  - Liquidation strategy

Turnaround Strategy

- Appropriate for the company that finds itself in a crisis
- Crisis: How to define it?
- Main causes for the crisis' development:
  - Poor management
  - Poor financial control
  - Market changes
  - Industry rivalry
  - Poor investments
  - Radical changes of process (interest rate, rate of exchange), etc.

Organisational Change Process

- 1st Phase: *Perception of the need for a radical change*
  - Phenomenon of a boiled frog
- 2nd Phase: *Fighting with the resistance to change & first positive reactions:*
  - Critical issue: building the dominance of all those that are in favour of changes
- 3rd Phase: Company's *revitalization:*
  - New vision & mission
  - Mobilization of the critical mass
  - Institutional changes

Key Issues for Achieving a Successful Turnaround

- Top management has to be convinced that a turnaround is really needed
- CEO has to have a vision
- Top management has to have a picture who will be the key “players” in a turnaround
- Educational & training efforts of the company’s human resources
- Usage of all limited resources purposefully for achieving a turnaround
- Open and effective informing

Characteristics of a Turnaround Strategy

- Change of CEO and in top management
- Centralization of financial management
- Divestment of some assets and business units
- Refinancing agreements with the creditors
- New marketing strategies
- Cost reduction
- Laying off of the surplus work force
- Infusion of fresh (additional) capital
- Withdrawal from non-core & concentration on core competences
- Changes in ther product-market matrix
- New strategic alliances
- New organizational structure, etc.

Phases in the Process of an Individual´s Turnaround

- 1st Stage: *Ending:*
  - Care, fear, pressure, resistance to changes, disengagement, demotivation, dis-identification, disorientation
  - Abandoning of searching his/her perspective in the old environment, a beginning of discovering new meaning and new values (management should offer a support to individuals in their advancements through this phase)
- 2nd Stage: *Neutral:*
  - Unbounding from previous co-workers, starting redirection & developing new behavior sample, process of “dying” of old habits and working style, emerging of new habits and working style, new reintegration with the new circumstances
- 3rd Stage: *New Beginigs* (new engagement & enthusiasm)

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