Restructuring a Company

2016

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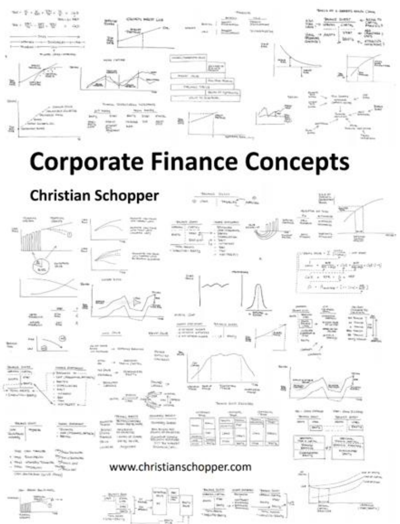


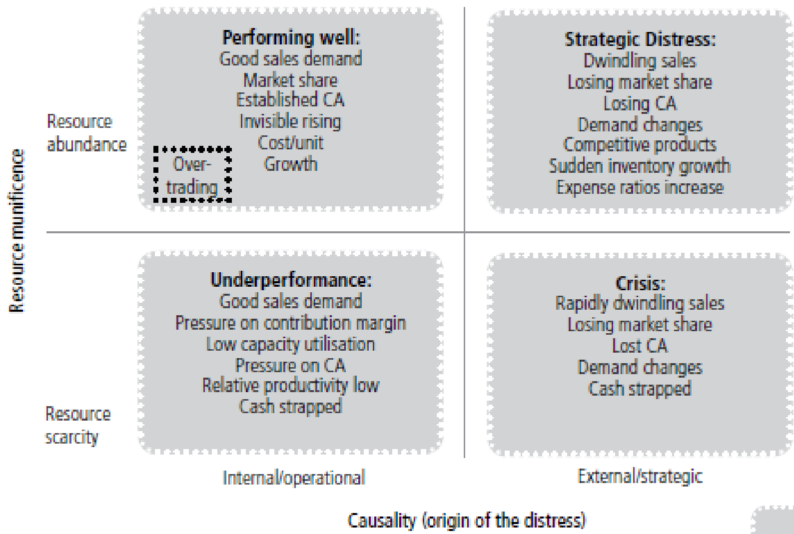
Introduction

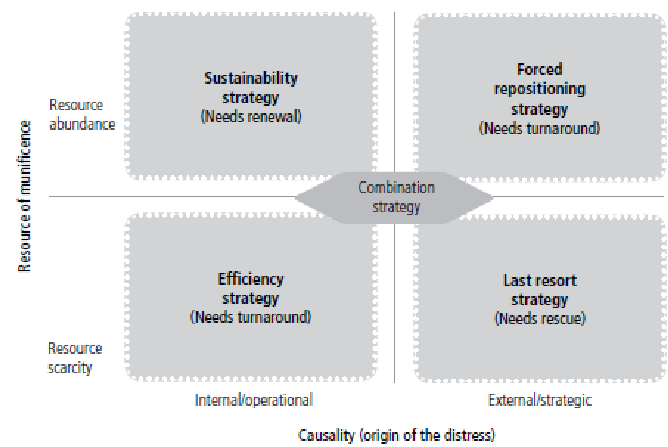
- Companies may need to be restructured to change their financial strategy or to help correct a market underpricing
- Changes in financial strategy normally relate to a **reduction in gearing by selling assets or raising new funds**
- In more serious cases, the restructuring might involve **renegotiating terms** with creditors, by **extending loan repayment** dates or by **swapping debt into equity**
  - This can be greatly complicated by the varying desires and legal claims of a variety of stakeholders, often in different jurisdictions

Some Warning Signs that Action May Need to be Taken

- The company is trading close to the **limit** on its **bank borrowing**
- Monthly management accounts continually show negative variances on sales
- There are no monthly management accounts, or they arrive late, with inadequate explanation
- Several **key people leaving** the company in a short period of time
- **Loss o**f several **customers**
- Poor relationships with suppliers

Strategies and Practices for Turnaround Situations





Strategies and Practices for Turnaround Situations (cont´d)

Turnaround situations	Turnaround strategy	Strategic practices
Growth	Sustainability strategy	Pursue sales (penetrate and new markets) Maximise market share Entrench CA Sustainable growth Optimise capacity Organic and inorganic Protect against overtrading
Underperformance	Efficiency strategy	Protect/strengthen competitive advantage (CA) Cost cutting Capacity improvement Generate cash Outsource non-essentials Productivity Asset reduction
Strategic distress	Forced repositioning strategy	Strategy revision Alternative revenue streams Find new products Alternative markets Forced to innovate, diversify Differentiate, acquire
Crisis	Last resort strategy	Defensive merger Divestiture Liquidation Ask for debt forgiveness

Reorganizations Addressing Internal Issues

- Put very simply, companies can face problems due to having the **wrong business configuration or** the **wrong financial strategy**.

- A company's financial strategy may be wrong because it has **too little debt**
  - A mature company which has remained equity financed should re-balance its debt/equity ratio, perhaps by paying out a special dividend or undertaking a share buyback
  - Alternatively, the company could put the money to good use by investing in a value-enhancing investment opportunity

- A company may have taken on **too much gearing** because of a deliberate, if misguided, financial strategy which has not worked out or that business conditions have changed

Goals of Corporate Restructuring – General Perspective

Restructuring	Principal Types	Applications
Governance / Managerial Restructuring	• Change in top levels of directors/managers • Change in internal organizational structure, pay	• LBOs, MBOs • CEO incentives
Strategic or Portfolio Restructuring	• Expansion, Diversification, Refocusing	• Product lines, brands, processes, territories
Strategic Alliance	• Joint ventures • licensing	• Common interest groups, partnerships • Exclusive or joint marketing or distribution relations
Financial Restructuring	• Equity, Debt, Dividends, Leasing	• Increase, Decrease, reschedule, convert, omit, sale & • Lease-back, securitization
Employee Restructuring	• Numbers, wage rates and Quality	• Increase, decrease, educate, train, motivate • Retirement benefits
Operational Restructuring	• Other operating costs	• Outsourcing, integrating, rationalizing, Cost control
MIS Restructuing	• Software and information systems	• SAP, Oracle, AS400
Bankruptcy	• By managers, by court administrator	• Allows modification of contractual obligations
State Aid	• Subsidies	• Free Loan guaranties, subsidized loans • Equity participation at higher than market prices.

Goals of Corporate Restructuring – Finance Perspective

- Any substantial change in a company's **financial structure**, or **ownership** or control, or **business portfolio** …
- … designed to **increase** the **value** of the firm …
- … by principle means of improving **capitalisation**, improving **debt composition** and / or change in **ownership** and control

What to Fix	What to Analyze
• Figure out what the business is worth now	• Use valuation model – present value of free cash flows
• Fix the business mix – divestitures	• Value assets to be sold
• Fix the business – strategic partner or merger	• Value the merged firm with synergies
• Fix the financing – improve D/E structure	• Revalue firm under different leverage assumptions – lowest WACC
• Fix the kind of equity	• What can be done to make the equity more valuable to investors?
• Fix the kind of debt or hybrid financing	• What mix of debt is best suited to this business?
• Fix management or control	• Value the changes new control would produce

Reorganization Strategies

- Reorganization strategies can fall into the following categories:
  1. Raise cash by **selling assets**, either outright sale of surplus assets or in a sale and leaseback transaction
  2. Raise cash by issuing **new equity** or another financial instrument
  3. Come to an **arrangement with creditors** to restructure existing debt

- In some jurisdictions, once it is decided that the company is savable under '**intensive care**", the process of reorganization will be in the hands of the current management of the company
  - This is the case in the USA, where companies go into **Chapter 11**, giving management time to sort out the problem
  - Regulations in other parts of the world take the power away from the management – for example, the UK has a **receivership process** which puts a bank-appointed receiver in charge of sorting out the business

Selling Assets

- If the company clearly has assets which are **not necessary** for the operations of the business, then realizing the value in them is an appropriate strategy

- **Issues** that may arise here include
  - Determining which assets are non-core
  - Finding a buyer
  - Being prepared to take the accounting consequences

- Problem: If it is known that a company is in financial difficulties, prospective buyers may bid low, or may decide not to bid at all, awaiting a possible "**fire sale**"
  - Or, if the company's problems have resulted from poor economic conditions or an industry-wide collapse, there may be a glut of such assets on the market, or indeed no market for them

Raising New Finance

- A company will **rarely** reorganize merely by **changing one thing**
  - If the crisis is severe, or is likely to become severe, several different restructuring strategies will need to be managed in tandem to achieve the greatest effect.

- New finance that is raised need not be in the form of straight equity

- It is sometimes possible for a company to raise the new funds in the form of a **convertible**
  - The advantage of a convertible to the investor is that there is some downside protection, but still the upside opportunity to make the risk worthwhile

Deep Discount Rights Issues

DEEP DISCOUNT RIGHTS ISSUES

Ahold

Early in 2003 Dutch retailer Ahold revealed accounting problems in a US subsidiary which left it with a large loss, a hole in its balance sheet, and its credit rating cut to junk status. The subsequent balance sheet reconstruction, which took place over that year and the next, involved the sale of assets and subsidiaries, a dramatic improvement in working capital management, a reduction of planned expenditure on fixed assets, and a deep discount rights issue.

The rights issue, in December 2003, raised about €3 billion. It offered two new shares at €4.85 for every three existing shares. Before the rights issue was announced the shares were trading at about €8.22, so this was a discount of 41%.

The theoretical post-rights price should have been €6.87 per share [(2 × €4.85) + (3 × €8.33) all divided by 5]. However, the 5% of the shares not taken up by the existing holders (the rump of the issue) were sold by the underwriters at €5.78.

ABB

Swiss-Swedish engineering company ABB also did a deep discount rights issue late in 2003, again as part of a balance sheet reconstruction. The company had become over-leveraged due to asbestos liabilities and a series of acquisitions that did not work as expected. In addition to asset sales, a bond offering and a renegotiated credit facility, the company raised some $2.5 billion in a rights issue at a 50% discount to the pre-rights price. (This was an unusual issue in that the price of the rights was increased after the initial announcement to reflect a market increase in the share price. The discount remained at 50%, but at 50% of the new, higher value.)

Source: Financial Times, various dates.

Renegotiating Existing Debt

- If a company can convince its **lenders** that they will ultimately **receive more by waiving interest payments or extending the term of a loan**, then debt terms can be eased to aid the company's short-term survival

- Such renegotiations normally only work in situations in which the creditor banks are owed a significant amount: "**The bank having a problem** …"

- One form of debt renegotiation is the **debt-for-equity swap**: Existing loans are released in exchange for the creditors taking an equity stake in the company
  - The argument that if the creditors insist on their debt being serviced and repaid, the company will be forced into liquidation and they will lose their money anyway
  - However, if the debt is converted to equity, the creditors – now shareholders – will share in the ultimate **upside** if this causes the company to recover

- This **new equity** will significantly **dilute** the **existing shareholders**.

- Difficulties involved in debt renegotiation are due to the **different interests of the various stakeholders** involved
  - Many banks may be owed money, with several different layers of debt, all with varying legal rights

Reorganization to Address Market Perceptions

- If a company is trading at a market value considerably below a fair value for its shares, companies usually try to pre-empt an opportunistic takeover bid for the company
    1. **Demerger**, to demonstrate the value in the group
    2. Blitz on **public relations** to change market perceptions
    3. **Take the company private**

- A **demerger** is when one listed company becomes two or more listed companies, generally with the **same shareholders** (at least initially)
    - In a demerger, the two resultant companies will be of approximately similar size

- In a **spin-off** a company divests itself of a division (i.e. a much **smaller** entity than itself) by distributing the shares of the subsidiary to its own shareholders, generally in the **form of a dividend**

- In an '**equity carve out**' a subsidiary company (or generally only a minority stake therein) is sold to the public as an initial public offering

Why Do Companies Undertake Demergers?

- **Focus management** on one side of the business, and put a separate management team in place to deliver value in a radically different type of business that has just happened to be part of the group

- A group including two or more very different classes of business can make it difficult for **analysts** and shareholders to understand, leading to an underpricing in the markets

Why demergers are seen to add value

- Separation into clearly defined business segments leads to **market transparency** and greater understanding
- The different businesses can follow **financial strategies** more appropriate to their activities
- Improvements in **corporate governance** and efficiencies arise in companies which were subsidiaries but are now separately accountable to the markets
- Incentive structures can be put in place that link management performance directly to the unit's share price
- **Removal** of the "**conglomerate discount**"

Summary

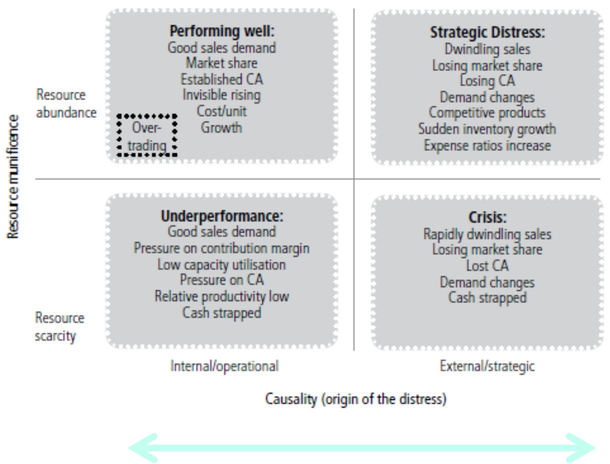
- Financial reorganizations can result from the need to correct external perceptions of the company, or can be due to the company needing to revise its financial strategy, generally to correct an over-geared position
- Re-balancing the debt–equity mix can be done by retrenching or selling surplus assets; by raising new funds; or by renegotiating existing borrowings, often swapping them into equity
- A reorganization often involves combining several different restructuring strategies. The strategies adopted will reflect the reason for the reconstruction
- The process of restructuring is complicated for global companies by the differing legal rights of creditors in different jurisdictions
- A demerger can change the market's perception of the company, clarifying the value in each of its parts. A carve out or spin-off can have the same value-enhancing effect

Appendix

Preconditions or Determinants of a Turnaround

- It is easier for a business to respond to operational problems …
  - Inefficiencies, cost relationship pressures, incorrect resource applications managerial deficiencies,
- … as there is room to manoeuvre and the contributing factors are more visible

- Strategic causes have to do with weak or wrong positioning in the market …
  - technological changes that govern demand determinants and loss of competitive advantage
- … that are not clearly visible to the decision-makers
- Strategic factors have a close relationship with the external environment
- Strategic causes generally require more speedy action

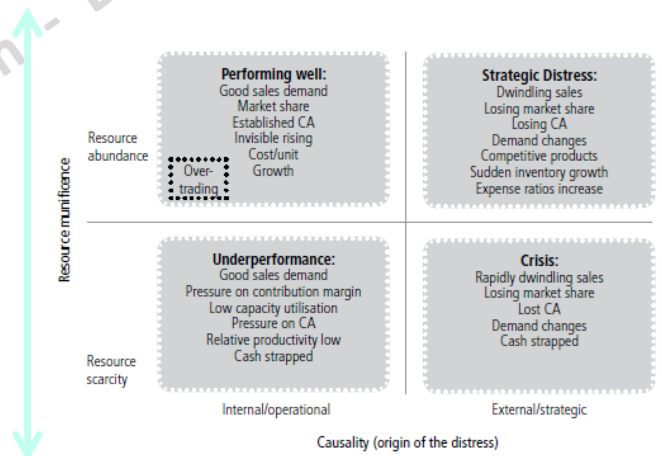


Preconditions or Determinants of a Turnaround (cont´d)

- Resource munificence refers to scarcity or abundance of critical resources that are needed when operating the firm

- Firms are mostly forced to attempt turnarounds at advanced stages of decline, when they typically experience huge resource scarcity

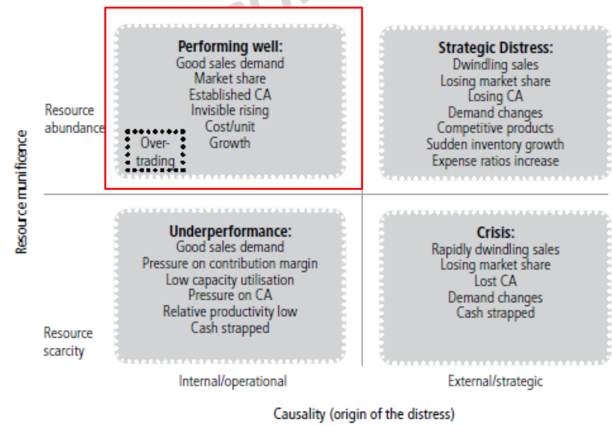
- However, it may also be required while they have resources but suffer from strategic causality

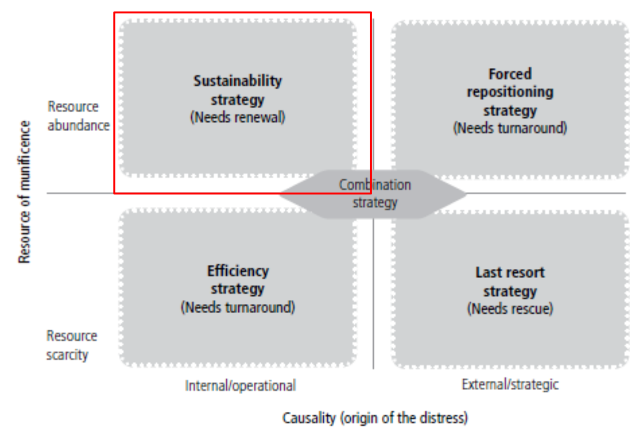


Preconditions or Determinants of a Turnaround (cont´d)

- Porter’s strategies can work fairly well in the performing well quadrant …
- … where there are abundant resources and operational causality

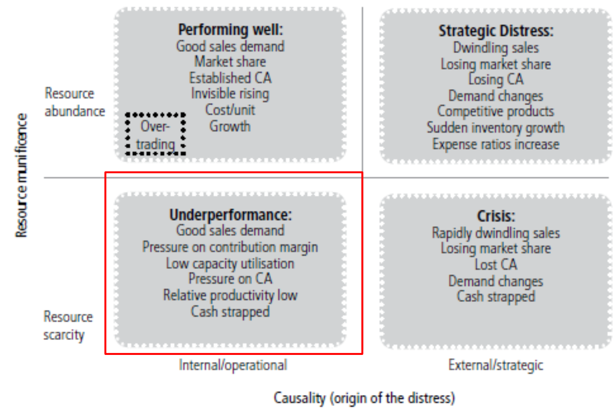
- Firms in this quadrant are generally not experiencing a need for a turnaround …
- … unless they fall in the overtrading trap

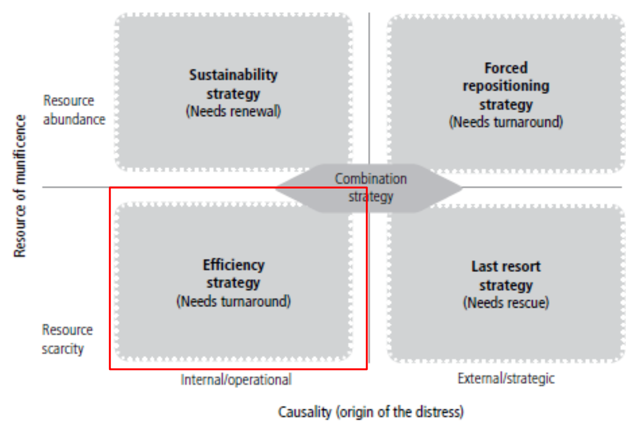




Preconditions or Determinants of a Turnaround (cont´d)

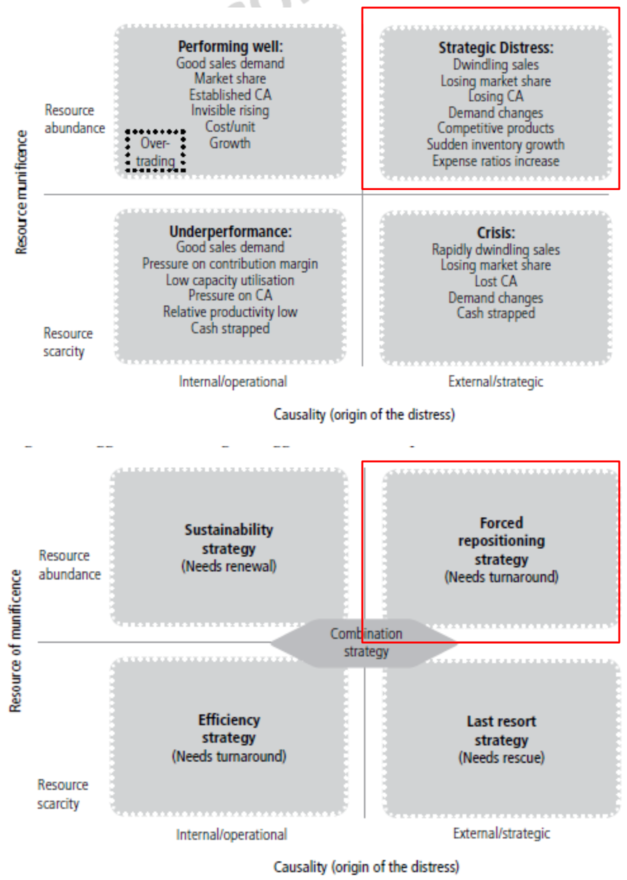
- The underperformance quadrant’s preconditions are characterised by scarce resources (limited slack) and problems caused by weak internal operations
- Despite good demand for its products, the contribution margin is under pressure, capacity utilisation is low, the competitive advantage comes under pressure due to the firm’s inability to respond to demand, productivity is low and the firm is cash-strapped
- Operations are weak and contain several types of inefficiencies such as rising inventory, low capacity utilisation and increasing debtor days
- Increases in both demand and inventory are contradictory but point directly towards the very inefficiencies that create the underperformance





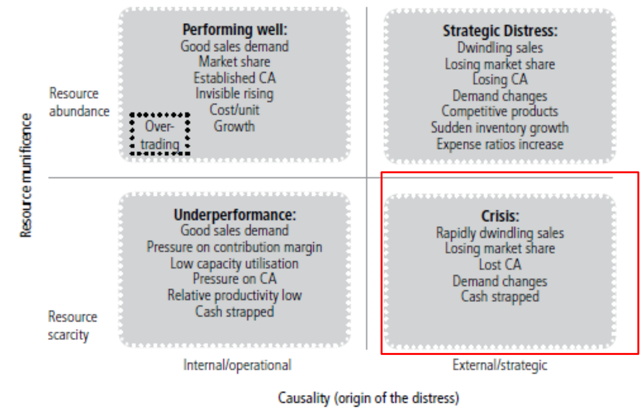
Preconditions or Determinants of a Turnaround (cont´d)

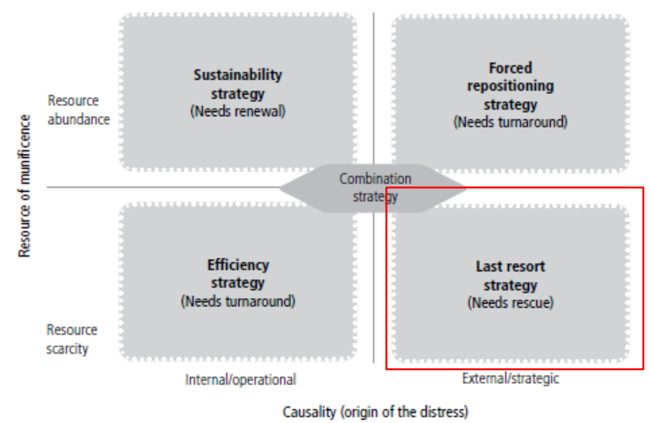
- Strategic distress is characterised by abundant resources but declining sales demand due to the loss of competitive advantage
- Market share is under pressure, probably due to growing demand for competitive or substitute products
- Underlying a rise in inventory is the loss in demand for its own products
- Because the firm has abundant resources, leadership is unenthusiastic about finding the real cause of the problem, namely loss in competitive advantage, and tends to blame it on temporary misfortune
- Management typically responds with increases in sales incentives, marketing and advertising budgets to overcome the problem, which they perceive as short-lived



Preconditions or Determinants of a Turnaround (cont´d)

- If nothing is done when in a strategic distress situation or the wrong strategies (those that drain resources or do not address the problem) are pursued, distress quickly turns into a crisis
- This quadrant's preconditions are characterised by scarce resources and the pressure on cash becoming more pronounced due to the reduced sales
- The firm is in the intensive care unit and needs rescue
- To increase sales, more credit is granted, which depletes cash levels even more
- Reduced advertising in an attempt to reduce cost weakens the competitive advantage further
- Basically the firm direction is south





Contact

Christian Schopper
Private: christian.schopper@aon.at
Business: christian.schopper@corpfince.com

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