# Business Restructuring as a Way to Improve Financial Position of Company

**INESE MAVLUTOVA**
Department of Finance, Assistant Professor, PhD
BA School of Business and Finance
Kr. Valdemara str. 161, Riga
LATVIA
inese.mavlutova@ba.lv,

*Abstract:* - On the ground of inconsistent economical environment consideration of ensuring market positions and future development possibilities is required of entrepreneurs. Restructuring is one of the most common scenarios in order to develop company. Motives of restructuring vary significantly, still the target is one – increase of company's market value and improve company's financial position in a result of implementing company's restructuring program. To achieve the objective the author examined conceptual basics of the company's financial strategy, clarified the world's tendencies of restructuring processes and study their development possibilities under inconsistent economical conditions, examined the methods of evaluating the company's market value used during restructuring process.

*Key words:* - Restructuring, Company's market value, Financial position, Risk, Effect of synergy, CAPM.

## 1 Introduction

During recession and after it a majority of companies experience financial difficulties, and one of the possibilities of managing them lies in the restructuring of the company.

Due to impact of inconsistent economical environment and processes of globalization life cycle of companies has shrunken and business has become more dynamic, which has encouraged processes of restructuring companies. Motives of restructuring vary significantly, still the target is one – increase of company's market value and raise of efficiency in a result of implementing company's restructuring program. Restructuring is a composite of numerous interrelated activities – from diagnostics to restructuring organizational structures and business processes based on modern management approaches.

As a result of research conclusion has been made that restructuring is a process aimed at maximization of company's market value by implementing methods of improving company's activity. During the process of enacting successful financial strategy the following targets are gained by restructuring the company:

- increase of company's equity value as an obligatory condition to increase the competitiveness,
- company's financial position is improving due to strengthening of its solvency, liquidity, financial stability and profitability,

The objective of the research – to justify attractiveness of restructuring used to improve the company's financial position, based on study of methods of modern financial management.

Generally accepted quantitative and qualitative methods of research in management science were used, including induction and deduction, analysis and synthesis, logically constructive and statistical methods, economic mathematical simulation, description and display methods of numeral information.

## 2 Business restructuring as a tool of financial strategy

It is examined during research that in scientific literature concept about strategy as a composite of conditions to make management decisions about future activities of the company formed in 20$^{th}$ century's early eighties. Enactment of strategically significant decisions is at first related to attracting monetary resources, respectively, to the quality of financial management in a company. The main component of financial management on the other hand is financial strategy, which includes establishment of sustainable system of financial activity's targets and indicators, as well as determining priority tasks for present perspective. In general financial strategy is defined as business

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policy in the matter of main directions of financial development.

Aspects of financial strategy are described in publications of *Van Horne J.*, *Vachowicz J.*[1], *Brigham E.*, *Gapenski I.*[2].

Company's financial strategy is developed with consideration of different fixed conditions or their predictable development. Since they are not taken into consideration often, especially in long-term perspective, it is always possible that set targets and planned strategic result will not be accomplished. Financial strategy's potential deviation from the objective is considered as consequences emerging from financial risk.

The matter of the complicity of activities related to preventing the difficulties is dependent on the complicity of the problems – starting with technical insolvency and concluding with bankruptcy.

During the *stage of owner's crisis* financial performance of the company worsens, which initially does not influence the payments to creditors. The criterion chosen is the limitation of interests of the owner, respectively, the real loss of owners investing.

Theoretical ground of offered criterion and numeral measurement is completely possible, despite of apparent abstractness. For owners the company is an object of investing financial resources, allowing to increase the value of the resources invested. In order to compare the effectiveness of investments, alternative investments with the same risk level can be used as the ground. Therefore, to determine the direct loss to owners, present market value and present initial investment value of the equity capital should be compared, considering that they will be used as alternative investments with the same risk level.

Thereby the following inequality can be used as the criterion of the first stage which is the owner's crisis:

$$\frac{TV_{pk} + D}{TV_{pam}} \langle 1, \text{ where} \qquad (1)$$

$TV_{pk}$ – company's market value;

D – owner’s dividends;

$TV_{pam}$ – present initial investment value of the equity capital with the possible alternative use of the resources invested with the same risk and liquidity level.

The insolvency of the company can be described both as episodic and chronic. In the latter case a huge possibility of bankruptcy may arise, which is understood as legally admitted or announced by debtor as inability to satisfy creditor's financial demands in full and/or inability to meet their obligatory payment.

Therefore to avoid situations of crisis, company's financial position has to be evaluated in a good time, so in case of instable situation composite of actions can be enacted in order to recover it. One of the key elements of the activity's system is ***restructuring of the company*** [3].

Together with integration in European Union the competition became more intense in several areas of entrepreneurship in Baltic States, so new requests for entrepreneurship methods were brought forward. Restructuring as a method of increasing market value of the company is common in industrial countries. However it is characteristic for Baltic market that bulk of small and medium size companies often uses irrational methods of financing. Therefore managing structure of financial sources and financial flow is irrational in these companies.

Considering the company as a complicated system, dependent on external and internal factors, ***company's restructuring*** is defined as changing the structure or as changing the business units. Considering the impact of both external and internal factors, restructuring includes improvement of company's management systems, financial, economic and strategic activities, marketing systems, personnel management, quality management and innovation management.

Low efficiency of the company's activity after the recession can be considered as the main cause of restructuring, which is reflected by poor financial indicators, scarcity of current assets, huge debtor and creditor debt amount and arriving at situation of crisis.

Matters of company's restructuring and their importance in the viability of companies in transition economies are studied by *Dockery E., Herbert W.E.*[4], *Crum R.L., Goldberg I.*[5] In general the scientists consider that the optimal speed of restructuring is dependent on desires of employees, culture barriers and existence of competitors desiring for addition of the company. Therefore the optimal speed of restructuring differs in every particular case.

With following to strategic and tactical targets, majority of the ***motives of restructuring company*** can be classified in following groups:

- Decreasing the outflow of company's resources (mainly the money);
- Increase or stabilization of company's inflow of resources;
- Motives leaving out the movement of resources.

By summarizing the motives of restructuring, a conclusion can be made that the managers and owners traditionally enact two targets: increase of company's competitiveness and further increase of company's value. Depending on targets and company's strategy one of the types of restructuring is chosen – operative or strategic.

Table I Structure of main restructuring motives

| Decreasing the outflow of resources | Increasing the inflow of resources | Motives leaving out the movement of resources |
|---|---|---|
| Effect of production scale<br>Cheapest information<br>Centralization of functions<br>Avoiding duplication<br>Rising effectiveness<br>Combining scientific studies<br>Decreasing prices of financial sources<br>Decreasing budgetary payments | Increasing solvency<br>Diversification<br>Motive of large enterprise<br>Biggest transactions<br>Mutually supplementing resources<br>Availability of information | Difference between market and book value<br><br>Motives of first level management<br><br>Protection from being taken over |

International practice in nowadays and skills of enacting restructuring in Baltic countries testifies that ***restructuring*** is one of the most complicated tasks of management. Restructuring is not simultaneous changes in resource and capital structure or in the economic activity in general. During this process several obligatory restrictions should be followed as well as the specific character of the company. Therefore the restructuring process can be enacted only when the targets are clarified, the concept of restructuring is justified and all the stages and methods are comprehended.

Together with more detailed examination it is noted that the term "***company's restructuring***" does not refer only to the activities changing the organizational structure of the company. It can mark all the complex of problems encountered by Baltic companies. It is clear that the restructuring targets are set by the strategy, while financial resources provides the ground of enacting it and defines the effect of enactment. That means that for justifying the targets of restructuring use of integrated financial strategy's definition would be the most appropriate, and to choose the type of restructuring by evaluating its results and effectiveness as well.

The author has concluded that an important part of *company's restructuring* concept is the classification of the types, because restructuring means crucial change of company's organizational, asset and capital structure. There are several approaches of enacting restructuring. The author prefers the following ***types of restructuring***: mergers of companies, acquisitions of companies, forming strategic alliances, restructuring of property, activities to eliminate financial difficulties. All types of restructuring are related to company's financial strategy.

No matter how formal the motives of company's restructuring are, its real objective is gaining additional effect (effect of synergy).

During examination of several Latvian and foreign expert conclusions, the author has concluded that during the process of restructuring the most appropriate concept for evaluating company's market value is the income concept which includes two techniques: capitalization of income and discounting the future cash flow [6].

Capitalization of income technique is the most appropriate for evaluating companies with the future activity matching to their former profile of activity, assuming that the speed of growth will be standard.

Capitalization of income technique refers to companies planning steady increase of income, thereby the possibilities of the use of it to evaluate company's market value during restructuring process is limited. Considering that company's restructuring prescribes that the economical activity of the company will be improved considerably by synergy or other activities, for evaluation of the market value former speed of growth is not considered. Different development scenario is worked out.

The technique of discounting the future cash flow is applied to companies with a possible difference between future and existing activity. The mostly used method of the technique is discounting the future cash flow. Technique of discounting the future cash flow defines company's capital value by its ability to make profits in the future – the company's produced cash flow in the future is discounted to determine its present value.

There are two main cash attraction sources for business purchasing transactions in the finance theory: equity and borrowed capital [7].

During the research it was clarified that a model exists which defines approximate costs of borrowed capital, using bond prices as a bench-mark. *The price of the borrowed capital* can be calculated with using the following formula (2):

The price of the borrowed capital = Income from the bonds + Premium of company's credit risk (2)

The equity price can be calculated by using two main methods acknowledged by world known financiers:

I. Dividend discounting model.
II. Capital asset pricing model or ***CAPM*** [8].

The most important indicator of company's economical activity is the increase of equity value; thereby the company's restructuring traditionally is performed in this direction. Company’s market value indicator as a restructuring criterion is not chosen randomly. As a result the owners are less interested in the sphere of the activity, technology used, parameters and characteristics of the goods and services produced and the market. Investment efficiency criterion is constant growth of investment value, which defines the increase of the owner's personal prosperity and a steady development of the company as well.

Company's market value is defined during evaluating business (operating company). By author, from the three traditional approaches the most precise are cash flow discounting method and income method to reflecting the company's internal value. It is determined by the high correlation of the cash flow, indicating the company's market value and the cash flow indicator including all the decisions related to economical, investment and financial activity.

The model of cash flow discounting method can be expressed in a formula:

$$V = \sum_{t=1}^{T} \frac{CF_n}{(1+r)^{(t-0,5)}} + \frac{V_{atl}}{(1+r)^T}$$

where (3)
***t*** – year for predictions,
***T*** – calculating horizon,
***r*** – discount rate,
$CF_n$ – cash flow during period ***n***,
$V_{atl}$ – terminal value outside the calculating period for predictions.

Company's value indicator calculated with the use of ***cash flow discounting method*** includes the achieved present value of the cash flow during stage of stabilization of the company (within predictable calculating period) and the discounted value of the cash flow outside the predictable calculating period. The cash flow is defined on the basis of net profit and depreciation deduction which is in hand of the company as target financial resources.

## 3 Business restructuring as a method of improving the management results

Traditional target of the restructuring is maximization of the company's market value. Development concept is managed by a defined methodology. In the first stage the company's market value before the restructuring must be calculated by the use of cash flow discounting method or income method. Afterwards different alternatives of restructuring economic, investment and financial activities have to be developed. Within the factors of economic activity decision analysis about the nomenclature of goods and services, price formation, cost effectiveness, markets, advertising sphere, sales and post sale services has to be performed.

The following can be attributed to investment factors defining the direction of the value: management of current assets and optimization of labor capital. Supplies, debtor and creditor liabilities, increase in capacity, planning the capital investments and selling the assets have to be analyzed. Equity value, proportion of equity and borrowed capital, structure of the capital are included as financial factors.

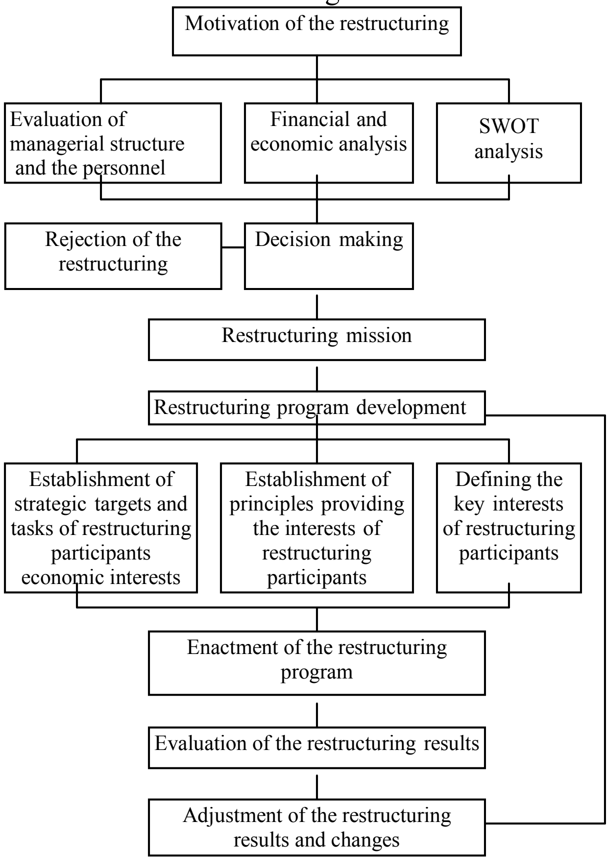
The developed activities were inspected with the use of ***company's evaluation model***. One of the criterions of choosing alternatives is increasing company's market value. The strategy aimed at increasing the company's market value is considered as a ground for restructuring alternative consideration described subsequently.

Restructuring strategies have to be reviewed “from the easiest to more complicated”, respectively, from the alternatives anticipating minimal capital investment and external funding to the investment projects renewing the technologies of goods and services provided. However it is important to consider that many companies experience the situation where the most important thing is to meet the creditor demands. It often does not conform to the traditional target of restructuring – maximization of company's market value, because the strategy is related to high level of risks.

The author has found a necessity for development of methodology of the restructuring model. It is based on a principle of improving the financial position of companies, which is linked to the needs of the company, its survival and successful development.

In order to solve the problems a model (Fig. 1) is offered by author which contains a row of sequential activities with a feedback which enables correction of targets and tasks in order to stabilize and improve the financial position of the company. The starting point of the model development is defining company's restructuring motivation and mission.

Fig. 1 Algorithm of establishing the company's restructuring model




The performed researches enable to make conclusion that the company's restructuring is related to high risk level.

The most significant risks with a negative impact on enacting the restructuring program are:

- wrong choice of restructuring method;
- prematurely evaluated restructuring results;
- insufficient qualification of the management;
- wrong evaluation of resources necessary to performing restructuring;
- insufficient motivation of the restructuring participants;
- emergence of negative social consequences during enactment of restructuring;
- inadequate legal coverage of the restructuring project.

By studying the process of forming cash flow during the enactment of restructuring program, it becomes clear that the discount rate is a indicator of capital investment efficiency when investing capital in the company, making decisions about purchasing the future income today and considering the acquirement risk. In order to make the right decision about investing capital in the company with analogical cash flows, the discount rate anticipates the risks related to capital investment in this kind of entrepreneurship.

Analysis of the failures is made and the factors are identified: increase of labor fluctuation, absence of strategy, insufficient evaluation of the costs, willful non-objective evaluation, Scarcity of the necessary control, slow decision making and uncertainty of the competition limits, barriers of cultural differences and scarcity of managerial experience.

Association of Financial Analysts offers the main listing of financial indicators in order to evaluate the company's financial position [9]. Financial ratios shown in the Table II are offered for the strategic financial analysis.

Table II The main financial indicators used in strategic financial analysis

| Indicators | Calculation |
|---|---|
| Return on equity, ROE | $\frac{\text{Net profit x 100}}{\text{Equity}}$ |
| Pretax margin, ROS | $\frac{\text{Earnings before taxes x 100}}{\text{Net turnover}}$ |
| Stock turnover | $\frac{\text{Net turnover}}{\text{Stocks}}$ |
| Debtor turnover | $\frac{\text{Net turnover}}{\text{Debtors}}$ |
| Days of sales outstanding, DSO | $\frac{\text{Debtors x 360}}{\text{Net turnover}}$ |
| Turnover Ratio of long-term investments | $\frac{\text{Net turnover}}{\text{Long-term investments}}$ |
| Total liquidity ratio | $\frac{\text{Current assets}}{\text{Short term debts}}$ |
| Quick Ratio | $\frac{\text{Cash + Short term capital investments + Debtors}}{\text{Short term liabilities}}$ |
| Cash ratio | $\frac{\text{Cash}}{\text{Short term liabilities}}$ |
| Debt–to–capital, DR | $\frac{\text{Liabilities}}{\text{Liabilities + Equity}}$ |
| Interest Coverage Ratio, ISCR | $\frac{\text{Earnings before interest and taxes}}{\text{Interest}}$ |

Of course, the company's economic activity's analyzes methodology does not give the answer to all the questions set by analysts and investors about defining the market value of the company analyzed, while it gives the concept of the key realities of the examined company – it makes possible to correctly compare the results gained by the company with the predictable future evaluation.

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The great amount of unsuccessful restructuring cases does not decrease the amount of performed restructuring projects because of their potential advantages when compared to the traditional methods of business extension. Therefore the causing factors of failures should be identified during the restructuring and the risks of enacting the restructuring have to be evaluated.

By determining the company's market value, it is concluded by the author that the most used method by Latvian financial analysts – the adapted capital asset pricing model or the cumulative method – does not reflect an adequate price of increasing financial risk. In order to determine adequate equity price correlating with the increasing financial risk along with more aggressive funding structures, the author offers using capital asset pricing method.

## 4 Conclusion

Based on analysis of the importance of restructuring in financial position improvement the author has concluded the following:

1. Crisis of the company is a difficult financial position threatening the existence of the company and demanding for particular activities in order to recover and retrieve the state of balance. Unlikely the temporary recession of economic activity following the development cycles and rotating with the rising phases, the crisis causes significant failures of the company's activity that can even completely change the company concerning its property, management, personnel and technical matters.
2. In order to eliminate the crisis, the financial position of the company has to be evaluated in a good time, and in case of instable situation set of activities has to be enacted to recover the company. One of the key elements of the system is company's restructuring.
3. Traditional restructuring task is a maximization of company's market value. Development concept is managed by a defined methodology. In the first stage the company's market value before the restructuring must be calculated by the use of cash flow discounting method or income method.
4. The real restructuring target is gaining additional effect (effect of synergy). As the best quantitative indicator to evaluate the effect, the company's market value indicator concept could be used. To evaluate the company more objectively it is necessary to use at least two of the concepts. For more active companies the income capitalization and discounting the future cash flow methods could be the most appropriate.
5. By determining the company's market value in order to define the minimal profitability or the equity price demanded by the owners, it is recommended to use the *CAPM* model. The use of *CAPM* in the countries without a highly developed stock market, including Latvia, is performed by using the stock index of the geographically and economically closest countries or regions, or the systematic risk coefficient of the industry (beta coefficient).

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