Corporate Restructuring and Value Creation

Abstract

The "Corporate restructuring" is an umbrella term that includes mergers and consolidations, divestitures and liquidations and various types of battles for corporate control. The essence of corporate restructuring lies in achieving the long run goal of wealth maximization. This study is an attempt to highlight the impact of corporate restructuring on the shareholders' value. Thus, it helps us to know, if restructuring generates value gains for shareholders (both those who own the firm before the restructuring and those who own the firm after the restructuring), how even the government will be in profit, and how these value gains have been created and achieved through corporate restructuring

N.S.Nanda
Assistant Professor
Srusti Academy of Management
Bhubaneswar

Sweta Mishra
Lecturer
Srusti Academy of Management
Bhubaneswar

Arpita Dash
Student
Srusti Academy of Management
Bhubaneswar

Introduction

Most of the Indian companies have adopted the 'maximization of long-term shareholder value? as their central corporate objective. Enhancing shareholder value in the long run involves, among other decisions restructuring and inorganic growth through mergers, acquisitions and divesture. In a changing and evolving legal environment restructuring is inevitable. The task on hand is to take it as a challenge and make it a mantra for building the new generation of successful and strong companies capable of competing in the emerging global economy.Value creation is the primary aim of any business entity. Creating value for customers helps sell products and services, while creating value for shareholders, in the form of increases in stock price, insures the future availability of investment capital to fund operations. From a financial perspective, value is said to be created when a business earns revenue (or a return on capital) that exceeds expenses (or the cost of capital). "Traditional methods of assessing organizational performance are no longer adequate in today's economy," according to Value Based Management net. "Stock price is less and less determined by earnings or asset base. Value creation in today's companies is increasingly represented in the intangible drivers like innovation, people, ideas, and brand." And one of the important tool for value creation in today's economy is "Restructuring".

Srusti Management Review
Vol.- IV, Issue-II, Jan-2011
pp. 87 - 94
ISSN 0974 - 4274

Restructuring is widely used in both the developed and developing countries now days. Companies and economies are restructuring to achieve a higher level of performance or to survive when the given structure becomes dysfunctional. Restructuring takes place at different levels. At the level of the whole economy, it is a long-term response to market trends, technological change, and macroeconomic policies. At the sector level, restructuring causes change in the production structure and new arrangements across enterprises. At the enterprise level, firms restructure through new business strategies and internal reorganization in order to adapt to new market requirements.

Definitions of Restructuring and Value Creation

The word *structure* used in an economic context implies a specific, stable relationship among the key elements of a particular function or process. To *restructure* means the (hopefully) purposeful process of changing the structure of an institution (a company, an industry, a market, a country, the world economy, etc.)This structure defines the constraints under which institutions function in their day-to-day operations and their pursuit of better economic performance. Restructuring can therefore be interpreted as the attempt to change the structure of an institution in order to relax some or all of the short-run constraints. Restructuring is concerned with changing structures in pursuit of a long run strategy. Crum & Goldberg define restructuring of a company as "a set of discrete decisive measures taken in order to increase the competitiveness of the enterprise and thereby to enhance its value". In this study, we define restructuring as a change in the operational structures, investment structures, financing structures and governance structure of a company. The objective of restructuring is to transform the company into an enterprise that is of high value to its owners. McTaggart, Kontes and Mankins [1994] define *value creation* as managing the performance of individual business units with respect to the cash flow generated or rates of return earned over time. The term value creation refers to improvements of the return on investment of owners by increasing the cash inflows and reducing risk. The value created in a business is measured by comparing the rate of return on assets (ROA) to the cost of capital (k) of a company. Value is created only when a business unit or a company can earn a return on assets that exceeds its cost of capital; when return on assets (ROA) falls short of the cost of capital, value is destroyed.

Corporate Restructuring and Value Creation in Developed Economies

The literature review on restructuring and value creation in the developed economies provides insight in the experience of success or failure of restructuring actions taken by management in creating value and the determinants of value in a business. These experiences can be useful for countries in transition in the Central and Eastern Europe and Sub-Saharan Africa too because the main goal of privatization and restructuring enterprises is to transform the entities into value creating capitalist firms.

Restructuring involves diverse activities such as divestiture of underperforming business, spin-offs, acquisitions, stock repurchases and debt swaps, which are all a one time transaction, but also structural changes introduced in day-to-day management of the business. Rappaport [1986] classified the above listed one time transactions as Phase I restructuring and those changes that bring continuous value improvement through day-to-day management of the business as Phase II restructuring. It can be understood that companies need to move from Phase I restructuring

to Phase II because in Phase II, the shareholder value approach is employed not only when buying and selling a business or changing the company's capital structure, but also in the planning and performance monitoring of all business strategies on an on-going basis. A successful implementation of Phase II restructuring not only ensures that management has met its responsibilities to develop corporate performance evaluation systems consistent with the parameters investors use to value the company, but also minimizes the Phase I concern of managers that a hostile takeover is imminent. We can say that managers should restructure companies to improve value, otherwise, external raiders will get an opportunity to take-over the company. Therefore, they claim that it is in the best interest of both managers and shareholders to keep the gap between potential and actual value as close as possible. Management can improve operations by increasing revenue or reducing cost, acquiring or disposing of assets and improving the financial structure of the company.

Company executives often restructure their companies for enhancing productivity, reducing costs or increasing shareholder wealth. Bowman, etal. [1999] summarized the findings of the corporate restructuring literature of 1990s that examined the impact of restructuring on performance. They classified restructuring activities into three categories, portfolio restructuring, financial restructuring and organizational restructuring.

Portfolio restructuring includes significant changes in the mix of assets owned by a firm or the lines of business in which a firm operates, including liquidation, divestitures, asset sales and spin-offs. Company management may restructure its business in order to sharpen focus by disposing of a unit that is peripheral to the core .Corporate Restructuring and Value Creation business and in order to raise capital or rid itself of a languishing operation by selling off a division. Moreover, a company can entail on an aggressive combination of acquisitions and divestitures to restructure its portfolio. According to the findings of Bowman et al. [1999] spin-offs and sell-offs generate gains while acquisitions and divestments generate no improvements on average. Of course these results have differed over time and also possibly over countries.

Financial restructuring includes significant changes in the capital structure of a firm, including leveraged buyouts, leveraged recapitalizations and debt for equity swaps. Financial structure refers to the allocation of the corporate flow of funds-cash or credit-and to the strategic or contractual decision rules that direct the flow and determine the value-added and its distribution among the various corporate constituencies. According to Donaldson [1994, p. 7], "the elements of the corporate financial structure include the scale of the investment base, the mix between active investment and defensive reserves, the focus of investment (choice of revenue source), the rate at which earnings are reinvested, the mix of debt and equity contracts, the nature, degree and cost of corporate oversight (overhead), the distribution of expenditures between current and future revenue potential, and the nature and duration of wage and benefit contracts." The findings of Bowman et al. [1999] revealed that financial restructuring generates economic value. A large part of the financial restructuring studies included were leveraged buyouts (LBO) and management buyouts (MBO). This evidences that managers have much more information about the true value of the firm's assets than outsiders.

Organizational restructuring includes significant changes in the organizational structure of the firm, including redrawing of divisional boundaries, flattening of hierarchic levels, spreading of the span of control, reducing product diversification, revising compensation, streamlining processes, reforming governance and downsizing employment. The findings of Bowman et al.

[1999] indicated that lay-offs unaccompanied by other organizational changes tend to have a negative impact on performance. Downsizing announcements combined with organizational restructuring are likely to have a positive, though small effect on performance. Since the dynamic environment within which companies operate is changing, financial managers should be ever alert to new and better ways of structuring and financing their business.

The value-creation process described involves the following:

1. Review the corporate financial structure from the shareholders' viewpoint .Consider whether changes in capital structure, business mix or ownership would enhance value.

2 Increase efficiency and reduce the after-tax cost of capital through judicious use of borrowing.

3. Improve operating cash flows through focusing on wealth creating investment opportunities (having positive net present values), profit improvement and overhead reduction programmes and divestiture.

4. Pursue financially driven value creation using various new financing instruments and arrangements (that is, financial engineering)." identified the following approaches to value enhancement: ability to command premium product prices, achievement of a reduced or lower than average cost structure, achievement of a reduced or lower than average capital intensity, ability to obtain debt at lower than normal cost, ability to obtain equity at lower than normal cost, design of capital structure that is more efficient than that achieved by major competitors, acquiring firms via the exchange of an overvalued equity, selling overvalued equity and purchasing undervalued equities. Successful enterprise level strategies depend on the value creation insights, which involve understanding of managers about how to improve the performance of business. According to Campbell, Goold and Alexander [1995] value creation insights are based on unique knowledge or experience of reasons why certain kinds of business have performance problems or fail to maximise their potential and ways in which managers can influence the business so as to raise performance. Value creation insights are extraordinarily diverse. Value creation insights are about major areas of improvement: raising performance, high improvement of the value of business, return on sales and sales volume. Value creation insights are linked to specific businesses that have performance opportunities and critical success factors, which the managers understand.

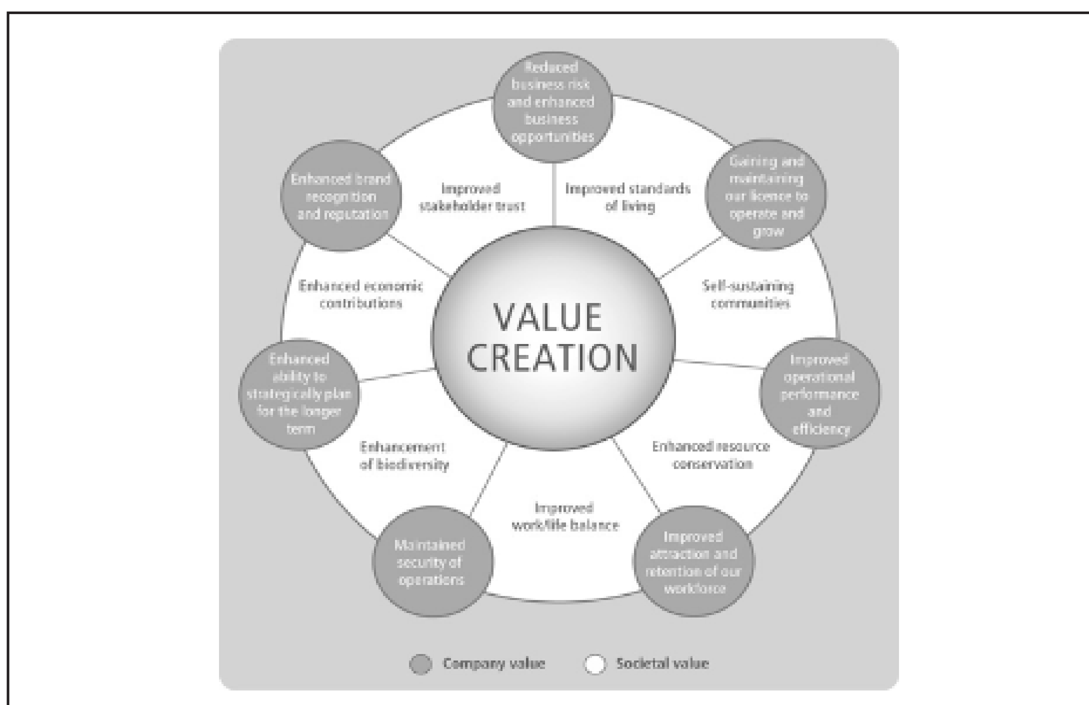
A focus on value creation implies that decisions and actions are judged in the context of how much value they will create and that value creating behaviour is encouraged throughout the organization. Establishing a culture driven by value creation demands a wide-reaching organizational transformation and in many cases, the most radical change is required at the top of the organization.

In this decade, consulting firms are adopting new approaches of Value based financial management systems to address perceived problems of the existing financial management systems. Value is created by improving operating efficiency, achieving profitable growth and rationalizing and exiting unrewarding business by liquidating unproductive capital and curtailing investment in unrewarding projects. The literature reviewed indicates that financial restructuring using leveraged buyout (LBO) and management buyouts (MBO) creates value because managers have more information about the true value of the firm's assets than outsiders and generates value by focusing on an

improvement of operations. The value based management (VBM) approach indicates that management decisions and actions are judged in the context of how much value they will create.

Corporate Restructuring and Value Creation in Transition Economies

In order to study the experiences of restructuring enterprises in transition, we reviewed the literature of the Central and Eastern European countries. In the literature, researchers have found that there is a need of restructuring enterprises pre and post privatization. It has been claimed that there is a need for an integrated restructuring plan that aligns changes in business strategy, enterprises finances and investment, control systems, marketing, operations and human resources. Simply letting the loss-making, insolvent enterprises collapse (in the hope that their assets, which in any case are highly specific, will be taken over by other healthier enterprises, or preferably, multinationals) proved to be misconceived and politically at least, too costly an option because doing so would have resulted in the collapse of practically the whole domestic industry. Major [1993] argues that governments frequently emphasizes that their intention to upgrade and restructure the state-owned companies first and to sell them later. The governments' chief argument is that in several cases, enterprises to be sold have vast potential that is, not reflected in the initial offer prices, and in order to obtain a much higher price for these companies, they must be modernized. During privatization, it might thus be important to devise policies to improve the performance of viable but at present loss-making and non-competitive enterprises that remain (for the time being) under effective control of the government. This raises important issues, of how to increase their autonomy and their profit orientation. If the enterprise potential value could be enhanced, restructuring could involve refinancing of debt, reorganising operations to reduce or eliminate unprofitable activities, slimming down the payroll or bringing in new management [UNCTAD, 1993].The banks had formal and informal options for restructuring enterprises with a debt problem (Figure 1)



When to Restructure Enterprises in Transition

One of the issues debated in the transition economies is when enterprises should be restructured. There are three possibilities of sequencing privatisation and restructuring enterprises during transition. These possibilities are:

1) Privatise the state-owned enterprises first without any attempt to restructuring the company "*as is*" and let the new private owners decide how to restructure the operations to create value.

2) Fully restructure the state-owned enterprise first then privatise it.

3) Partly restructure the state-owned enterprises before privatisation and let the new owner decide how best to complete the task.

Privatisation without restructuring usually results in a low price for the enterprises. But restructuring to gain a better purchase price is costly and difficult. Lack of clarity about who has, and will have ownership rights vis-à-vis enterprises results in tremendous uncertainty about the future of incumbent managers and management bodies (such as enterprises and workers councils). This prompts a waitand- see attitude, which does not stimulate structural change. The resolution of this uncertainty is critical for eliciting the much needed supply response through restructuring during the transition Most of the factors that caused the poor performance in the first place remain. It is difficult to motivate management and staff to improve performance if their jobs will be at risk from privatisation. Restructuring measures pursued before privatisation may also differ markedly from the direction intended by subsequent buyers.

Restructuring programs should be undertaken mainly to deal with problems, which the private sector cannot or will not deal with, as early steps in the transition.

Policy has been focused, according to UNECE [1993], too much on the divestment of large state firms, while the possibilities for improving their performance were not sufficiently explored. Systemic change in itself has already reduced or eliminated many growth retarding factors: the priority treatment of the military sector and the ideological commitments to full employment. After removal of these impediments, state-owned companies may have a good chance to improve their performance relative to the past. After a decade of transition experience in Central and Eastern Europe, researchers indicate that enterprises require pre-and post-privatisation restructuring. In the preprivatisation, the government should restructure companies by shedding labour, preferring some financial restructuring, such as debt reduction and by introducing hard budget constraints to make companies autonomous and profitable. However, the new owner, who has the ability and entrepreneurial drive to commit funds and run the business on a market oriented basis, should make major investments in equipment, modernising technology, developing new products and by large investments in research and development..

Conclusions

Value based management system helps managers to focus on activities that create value. The value based financial management system also emphasises operating efficiency improvement, investing in profitable projects and terminating unprofitable projects and a judicious use of finances

to create value. The restructuring shows that financial restructuring creates value because it does not bring change in company management the value drivers to the enterprise objective of value creation. Since the managers know more about the company than outsiders they can introduce changes in operations and investments once they get access to finance Labour reduction, unless accompanied by other organisational changes, does not increase firm value. The restructuring experience of transition economies indicated that there is even a greater need for restructuring of enterprises than in those enterprises in the developed economies. In the transition economies also governments are engaged in financial restructuring of companies to reduce the debt accumulation in companies in order to attract buyers. Many governments directly wrote off the debt. However, this creates moral hazard if this is done repetitively, because it then gives managers an idea that the government will bail out the financially troubled companies and it destroys the credibility of the reform process. However, the attempt of assigning enterprise restructuring to the banks had some positive influence on enterprise performance. The banks created departments staffed with experts in managing financially troubled companies and also participated in the governance of the enterprises as boards. The bank led enterprise restructuring also provided several alternative methods of reducing the enterprise debt such as debtfor- debt swaps, debt-to equity swaps and debt sale. The people of the transition economy countries believe that selling companies at a low price without restructuring is giving away the wealth of a society to a few private individuals. Moreover, there is uncertainty of potential restructurability of the enterprises and since the managers know their companies better than outsiders, they will be better equipped to restructure the enterprises than outsiders. The buyers also will be happy to acquire restructured companies because it reduces the uncertainty of restructurability of the enterprise to be sold. For all parties, selling the restructured enterprises is the best option. Segregating unprofitable business units and restructuring large conglomerates into viable business entities enhance the saleability and viability of enterprises. The governments of transition countries need to engage on defending the vulnerability position of the company by providing finances and strengthening management of the companies to help them compete in the market economy.