

EVALUATION OF RISK DURING THE RESTRUCTURING PROGRAM

Inese Mavlutova

BA School of Business and Finance

e-mail: inese.mavlutova@ba.lv

Abstract

Motives of restructuring vary significantly; still the target is one – an increase of company's market value and raise of effectiveness as a result of implementing the company's restructuring program. Thereby these processes are crucial for stimulating entrepreneurship. During restructuring of the company, negative results are also possible. Several significant risks are known being able to impact the implementation of the restructuring program negatively. Apparently, the analysis of failure causes and offering techniques to decrease existing business risks are necessary.

Keywords: business restructuring, restructuring results, risk, risk premium, restructuring failures.

Introduction

Due to the impact of inconsistent economical environment and processes of globalisation, the life cycle of companies has shrunk and business has become more dynamic, which has encouraged processes of restructuring companies. Motives of restructuring vary significantly; still the target is one – an increase of a company's market value and raise of efficiency as a result of implementing the company's restructuring program. Thereby these processes are crucial both for stimulating entrepreneurship and development of the national economy in general.

Reorganisation is considered as the main stage of restructuring company to implement further activities of attracting investments and establishing optimal owner structure. However it is important to remember that positive results of restructuring company can be achieved given the following conditions: production and investment programs are developed; grounds for financial and economical determination are established in order to create new structures; potential investors are found; legal rights of movable property and real estate are executed; chosen alternatives of reorganisation are supported by owners of a company.

The objective of the paper is to analyse risks related to restructuring and offer methods to manage them.

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.

Classification of risks

During restructuring of an enterprise, negative results are also possible. Several significant risks are known being able to impact the implementation of the restructuring program negatively.

Risk number one is related to incorrect choice of the restructuring technique. As mentioned above, the choice of the restructuring technique is determined by a strategy, targets and condition of the enterprise itself.

If a decision about performing operative restructuring is made, application of several techniques is possible. Firstly, it may be restructuring of assets, like rental, conservation, liquidation, writing off assets, selling assets. Secondly, restructuring of accounts payable, like invalidating debts, lengthening debts, dividing debts with a following refund, refunding debts by minimising costs, redemption of creditors' payment rights with a following prosecution, etc. Thirdly, restructuring of accounts payable which provides for gaining maximal economic effect, invalidating the debt and forms of dismissing or cutting personnel.

Risk number two is premature evaluation of restructuring results. In practice it is hard to determine, when the actual results of structural changes will appear. Temporary negative effects of the restructuring are often considered as the final result. In this case all the actions may be interrupted without achieving the strategic targets. The risk can be minimised by establishing a competent restructuring programme containing a detailed description of temporary results and target indicators, as well as by determining the long-term targets.

Risk number three is insufficient qualification of the enterprise managers. In order to reduce the risk, two techniques may be applied: firstly, dismissal of the company's managerial staff and formation of a new team or, secondly, organising different seminars and lectures for the managers, in order to explain the targets

and main directions of the restructuring. To determine and skilfully handle the possible risk, professional specialists are involved.

Risk number four is incorrect evaluation of the restructuring resources necessary. Usually in enterprises the restructuring complexity level is evaluated inadequately, thus the implementation time limit is restricted, the number of the specialists involved is small and the funding is insufficient.

Risk number five is related to insufficient motivation of the participants involved in the restructuring process. It is not only different levels of interest in structural changes of the employees, but also a conflict of interests between enterprise managers and owners that can influence their motivation negatively during the restructuring process. In order to eliminate the risk, the restructuring must be initiated "from the top down" and not vice versa.

Risk number six is emergence of negative social consequences during the implementation of restructuring, which is considered a completely usual practice in countries of market economy. It manifests as a reduced personnel and a mass dismissal in the enterprises being liquidated, as well as shutting down the social enterprises.

Reducing personnel and cutting off social assets in enterprises was common in Latvia during the middle nineties of the last century.

Risk number seven is low quality of the restructuring project's legal ensuring. During restructuring process it is often necessary to make legal changes. In Latvia the most common legal changes are establishing one or more subsidiary companies on the basis of the existing company, establishing new enterprise together with owners of a bankrupting company, bankruptcy of an enterprise, restructuring by dividing the enterprise or separation.

By studying the process of forming cash flow during the enactment of restructuring program, it becomes clear that the value of money depends on the timing, respectively, it is impossible to link cash flows applying to different time periods of the program enactment. In author's opinion, discounting (determining the present value of the future money) should be used in order to adjust the cash flow amount (Van Horne and Vachowicz, 2008).

The interest rate is called the discount rate when calculating present value. It can be determined in two ways:

1. The discount rate is the rate of return or the profitability acquired from alternative investments – it is the value of an alternative exploitation of the company's capital.
2. The discount rate is the profitability rate expected by the buyers of securities – it is the value of the alternative exploitation of an investor's capital.

The discount rate used to determine the present value of money in the obstacles of economic reformation is composed of three parts:

1. Cost for refusing to use the money alternatively.
2. Inflation premium.
3. Cost for risk.

Using these indicators is also typical for businesses in Latvia.

When scheduling the cash flow during restructuring, the discount rate is understood as the expected profitability rate of the capital invested in objects comparable by the risk level or as the expected profitability rate of the existing alternative investments comparable by the risk level during the evaluation. Discount rate is used to determine the amount of money, which the investor would have paid today for the rights to receive the expected future income.

The basis of cash flow calculation is also the basis of discount rate calculation. The discount rate equals to the rate of return on invested capital demanded by the owners is applied to the equity's cash flow. In the discounting process WACC (Weighted Average Cost of Capital) is typically used as a discount rate for total cash flow, where WACC is a weighted average cost of equity price and the price of borrowed capital.

The discount rate is a ratio of capital investment efficiency when investing capital in the company, making decisions about purchasing the future income today and considering the acquisition 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. The discount rate assumed by the evaluator has to comply with the type of cash flow. Total cash flow complies with discount rate calculated by WACC method.

Equity's cash flow complies with the cumulative discount rate calculation or calculation by CAPM (Capital Asset Pricing Model). Discount rate including inflation in case of an actual use of the cash flow

must be adjusted by the inflation rate according to the *Fischer* model, expressed by a following equation (Fuller Russell and Chi-Cheng Hsia, 1984):

$$r = \frac{R - i}{1 + i} \quad (1), \quad \text{where}$$

r – actual discount rate, non-including inflation,
 R – nominal discount rate,
 i – the level of inflation.

If the inflation rate does not exceed 10%, a simplified formula of the Fischer model has to be applied (Fuller Russell and Chi-Cheng Hsia, 1984):

$$r = R - i \quad (2)$$

When applying the cumulative discount rate calculation, evaluation of factors able to cause failure of receiving the planned future income is scheduled. Non-risk profitability rate summed with profitability rate on total investment risk of the enterprise is assumed as the basis.

Cumulative method most completely includes all the investment risks related to economics' and industry's factors of general characteristics and the specifics of the enterprise being evaluated.

Determining discount rate by the cumulative method is based on the expert evaluation of the risks related to investing in the business being evaluated. The discount rate is calculated by summing up all the defined risk values and then adding the risk-free rate of return.

Table 1

Factors determining the amount of risk premium

| Risks | Premium |
|-----------------------------------|---------|
| Manager und quality of management | 0 – 5% |
| Level of enterprise | 0 – 5% |
| Financial structure of enterprise | 0 – 5% |
| Diversification of customers | 0 – 5% |
| Diversification of clients | 0 – 5% |
| Return on sales and forecasts | 0 – 5% |
| Risk of industry | 0 – 5% |

In order to guarantee the reliability of calculations, discount rate can be calculated by another method – the CAPM. This method is based on assumption that the investor aims at gaining additional revenue in comparison to the revenue guaranteed from the risk-free investments. Gaining the additional revenue is related to a high risk level. CAPM allows determining the expected additional return on assets and schedules determining discount rate by the following pattern (Sharpe, 1964):

$$K_E = R_F + (R_M - R_F) \times \beta_E \quad (3), \quad \text{where}$$

K_E – rate of return on equity
 β_E – beta coefficient
 R_F – risk-free rate
 R_M – risk premium of industry.

CAPM is widely used worldwide and it is considered to be one of the most equitable methods, since it is based on the informational data of the real market. In order to apply this method in Latvia, necessary corrections have to be performed.

In the developed countries with balanced market the most reliable liability guarantor is the government. Interest rate of the government securities is usually determined as the risk-free rate.

When calculating premium and beta, usually data obtained by analysing investment market of corporations with stocks quoted in stock exchange are used, and only afterwards the premium of small enterprises is adjusted.

The specific business activity related risk of the particular enterprise being evaluated is added to the premium as a risk typical only to the particular enterprise.

Considering quotation of additional changes, calculation of discount rate by CAPM can be expressed as the following pattern:

$$K_E = R_F + (R_M - R_F) \times \beta_E + S1 + S2 + S3 \quad (4), \quad \text{where}$$

K_E – rate of return on equity,
 β_E – beta coefficient,

R_F – risk-free rate,
 R_M – risk premium of industry,
 $S1$ – risk premium of small enterprise,
 $S2$ – risk premium of the particular enterprise,
 $S3$ – risk premium of country.

Beta coefficient is assumed to be the limit of the systematic risk, indicating the sensibility of securities concerning the future market fluctuations. Average beta coefficient draws closer to **1** for all enterprises. The coefficient is greater than **1** for securities with value greater than the average fluctuation, and less than **1** for securities with smaller fluctuation value. Securities with the beta coefficient greater than **1** possess greater risk level, while securities with the beta coefficient smaller than **1** possess risk level smaller than average. If the beta coefficient equals **0**, the investment risk of the securities also is close to **0**, but the profitability of securities is relieved from the risk.

Due to the increasing number and range of restructuring operations, as well as profitable opportunities during the last decade, a concept of obvious advantages of this kind of enterprise development may appear. However there are many studies proving that this assumption is false. The majority of enterprise restructuring techniques do not help to achieve the targets desired. The results of studies performed by independent experts are displayed in Table 2.

Table 2

The results of restructuring operations

| Source | Date of publication | Country | Research limitation | Results | | |
|--|---------------------|-----------------------------|---|-----------|---------|----------|
| | | | | Successes | Neutral | Failures |
| Measured by the amount of deals | | | | | | |
| Jansen/Koemer | 2000 | Germany | 103 internal and external mergers 1994 – 1999 | 44% | | |
| Measured by achievement of goal | | | | | | |
| Booz-Allen Hamilton | 1998 | World | 150 Companies | | | 34% |
| Measured by increasing company's market value | | | | | | |
| Jansen/Koemer | 2000 | Germany World | 103 internal and external mergers 1994 – 1999 | 24% | | |
| McKinsey | 2000 | World | 507 mergers/ acquisitions | | | 50% |
| KPMG | 2000 | World | 107 - 700 international mergers/ acquisitions 1996 – 1998 | 16% | 30% | 54% |
| A.T. Kearney | 1999 | America, Europe, Asia | 115 mergers 1993 – 1996 | | | 58% |

Independent experts have stated that 76% of restructuring operations are unsuccessful (PricewaterhouseCoopers, 2008). Of course, separate studies are hard to compare, since interpretation of methods and scope of gathering statistical data necessary, techniques of analysis and understanding of the term *successful business* differs. The studies performed enable to conclude that restructuring is related to a high level of risk. Furthermore, the number of unsuccessful businesses does not decrease over the time, which may be surprising, since enterprises having experienced failure should be more careful in future and specialists and consultants participating in the businesses should become more experienced by taking into consideration mistakes made in past in order to succeed with upcoming projects. Unfortunately, statistics does not approve this assumption. One of explanations of this phenomenon can be continuous changes of external conditions determining that the experience obtained cannot be used in relation with changes of general conditions. The second explanation – the experience obtained is not systematised and recorded.

Unfortunately, the great number of failures does not decrease the amount of restructuring businesses performed, since restructuring possesses obvious potential advantages compared to traditional techniques of expanding business. Apparently, the analysis of causes of failure and offering techniques to decrease similar business risks is necessary.

Analysis of the restructuring failure causes

The following reasons may be identified within the task mentioned above:

1. Increase in labour turnover. One of the most significant issues when merging or incorporating enterprises by force is an increase of staff fluctuation, which is particularly significant in the forced merger cases, since the restructuring process demands a serious personnel cutting in order to centralise and eliminate the overlapping functions. However, usually the desirable fluctuation differs from the real one. Most of personnel begin searching for a new job, since they are not sure about their existing position. Another reason for searching a new job is moral causes or unwillingness to work for “strangers”, which is particularly attributed to managerial staff.

It should also be admitted that during this kind of fluctuations, the majority of highly qualified staff and high-level managers leave the enterprise, and there are no difficulties for them to find a better job opportunity. Together with them, the enterprise loses not only its “*know how*”, but also a part of clientele, which has been in friendly long-term relationships with those, who left.

The enterprise’s costs are sharply increased by the fluctuation due to increasing sum of total allowance for quitting, as well as increasing costs of advertising for new, qualified staff and its training. The lack of qualified personnel negatively impacts the business, the image of the company deteriorates, customers leave and conception of unsuccessful restructuring arises.

2. Absence of strategy. After overcoming all the difficulties (looking for adequate applicants, managing negotiations, going through formalities necessary for signing the agreement) it often turns out that managers have no further ideas and resources to implement further integration. This is typical for enterprises in subordination to forced mergers for the purpose of diversification. Restructuring without strategic consideration often results in selling the purchased assets after unsuccessful efforts of trying to adapt to new conditions. Besides, outflow of the resources necessary for traditional business may cause a decrease in overall profitability indicators and liquidation of the business itself. According to the survey conducted by independent experts, one third part of enterprises perform restructuring without detailed analysis of strategic future advantages. Also advantages of quick decision making are supplemented with drawbacks related to significant waste of resources. For example, *Deutsche Telekom* purchased part of *Barak* company, even though Israel was not considered as a prior market. Consequently the holding company suffered significant amount of losses due to the unconsidered decision, and it is still unable to dispose of the unnecessary purchase.

3. Insufficient evaluation of costs. Insufficient evaluation of costs of integration, new image development and restructuring of marketing and sales departments is a very common mistake, which, according to different calculations, can add up to one third of the total sum of the business.

Integration costs exceed the planned costs three times; in addition, the time limits usually are not complied with. During the cost evaluation process previous experience in mergers (*benchmarking*) is ignored, no actions for unexpected circumstances are planned, and all the actions are performed based on unrealistic conceptions.

A large amount of components are not included within the total cost evaluation: renewal of personnel during the fluctuation, costs of corporate culture uniting actions, costs of organising “*know how*” exchange and establishing new management techniques.

4. Intentional biased evaluation. Employees developing a business plan are often the persons concerned, therefore using unrealistic and too optimistic parameters while performing the job. The desire of first level management to increase salary by increasing total value of the business and to obtain greater power is possible as well. The second reason may lie in efforts to gain business restructuring experience.

5. Lack of the necessary control. Another significant problem is the lack of systemic indicators necessary to evaluate the restructuring process’ success and the level of achieving targets. In order to evaluate restructuring results, aggregate financial results of a merged enterprise are usually used, which is not sufficient to determine the “bottlenecks” and perform necessary adjustments on time.

This problem is linked with the fact that no particular restructuring plan is established, which includes integration plan and schedules additional processes, executives, targets chosen, qualification and continuous control of gaining the results. In practice all the problems are usually dealt with, when they arise.

Furthermore, an executive is chosen (often without the qualification necessary), who fights the consequences instead of finding the causes, since he/she does not control the general situation. Thus significant losses of time and money arise, if strategic control of the whole restructuring process is not established.

6. Slow decision making and uncertainty of competency limits. Restructuring process is often moved from one department to another due to uncertain limits of competency. There are a significant number of hierarchy levels of operational staff and decision making committees holding back the process and impacting negatively the general atmosphere. Information and suggestions for board of management are presented once a month or even more infrequently, and that holds back the work, since the committee deals not only with strategic and tactical, but also operational issues. Slow decision making during such a dynamic process as restructuring not only delays it, but also provokes the loss of various opportunities.

Often new job positions are being divided, while restructuring process is still not finished. Besides, the struggle absorbs much more energy than creative activities of integration establishment and profit making.

7. Barriers of cultural differences. Insufficient evaluation of cultural differences causes hardly predictable obstacles during negotiations and integration process. For example, criticism about changes of circumstances expressed during the forced merger of the company *Matav* was received as an attempt to offend, therefore, the negotiation process extended significantly. Basically the Hungarian company discussed all the criticised statements beyond the frames of the main negotiations, which filed only the basic agreements. Emotional behaviour during negotiations is characteristic to representatives from Southern countries – they perceive criticism as an aggression or personal antipathy.

Not only nationality is counted as a cultural difference – it also includes corporate culture of the merged enterprises. After Latvia joined European Union many enterprises were purchased by the enterprising neighbours, but the majority of employees perceived the dynamic managers from Western countries negatively – they were blamed to be arrogant and willing to change the usual, slow routine. Under the mentioned influence many Latvian managers were constrained to leave the enterprises or to adapt to the new circumstances.

8. The lack of managerial experience. Restructuring projects are very different from simple, though important businesses, therefore, managers must possess particular qualities. The large number of failures appears in circumstances, when a manager lacks experience of restructuring establishment, but during the process relies only on herself/himself. Optimisation tasks of ongoing processes are very different from their development tasks. Techniques and the manner of managerial thinking previously approbated and proven to deliver positive results in business stabilisation circumstances, may not be optimal or is even completely unacceptable. A project manager meets circumstances with significantly greater number of unknown measures compared to usual circumstances. Even if understanding the scope of the task and his/her incapability to deal with it, he/she does not admit it, thus worsening the situation even more.

Conclusion

The performed research allows making a conclusion that restructuring of a company is related to high risk level.

- Moreover the amount of unsuccessful transactions do not decrease, therefore the companies with negative experience should be more careful in future, while participating specialists and consultants have to obtain the necessary experience in order to succeed in consideration of the mistakes made.
- Unfortunately statistics do not confirm the assumption. One of the explanations could be that the external conditions change constantly, and consequently the experience obtained cannot be used because of the changes in general conditions. The second reason – the previously obtained experience is not being systematised and accumulated.
- Foreign scientists and specialists have admitted that a particular restructuring program has to be developed, however, the author concluded that in foreign literature on management conventional methodology of organising and enacting the restructuring cannot be found. The author offers using the established step-by-step enactment program of the restructuring.
- 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 factors causing failures should be identified during the restructuring and risks of enacting the restructuring have to be evaluated. One of the alternatives is the systemic analysis of main risks and related factors identification offered in this article.

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