

# RESTRUCTURING OF BUSINESS AS A WAY OF INCREASING A COMPANY'S VALUE

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**Abstract:** Business managers in Latvia divide restructuring into two main kinds. The strategic restructuring is intended to increase the value of equity for shareholders, keep the corporate property and deal with other issues for an enterprise to maintain its functional condition. The restructuring of companies in a situation of crisis is focused on the restructuring solutions for insolvent or bankrupt enterprises to lead them back in the condition of functional enterprise.

In generally, restructuring is the corporate management term for the act of partially dismantling and reorganizing a company for the purpose of making it more efficient and therefore more profitable. It generally involves selling off portions of the company and making severe staff reductions.

**Key words:** value of business, corporate restructuring, merging of companies, synergy effect

## 1. Introduction

The object of this article is restructuring of business that can be used to improve company's financial statement, prevent its bankruptcy and increase company's value.

The main goal is to prove that restructuring of business is one of the most important decisions of company's value increasing.

The author of the article suggests that the increasing of company's value can be measured using traditional financial analysis methods (coefficients, patterns) as well as calculating the effect of restructuring as a variation of investment with initial expenses and forthcoming profit in the future.

For the time being the international practice and experience of restructuring suggests that it is one of the most difficult managerial tasks.

The author of this article reviews existing methods of enterprise financial statement analysis as well as methods of cash flow discounting. The author analyses which existing method of restructuring that can be proposal used in transitional economics, for example, in Latvia.

## 2. The main restructuring content

Methods of business restructuring to prevent bankruptcy of enterprise and improve its financial position are frequently applied in developed countries. A characteristic feature of rather new Latvian market is that financing methods and organization, as well as cash flow management, used by most of small and average businesses, are not rational. The financial instability causes high rate of bankruptcies among new enterprises.

The low level of financial management, and inability of financial managers to apply anti-crisis mechanisms in time, rather often is bound up with lack of knowledge specializing in methods and practices of contemporary anti-crisis management.

Restructuring is not a single transformation in the structure of capital or production. It is a process demanding an account of many restrictions and peculiarity of the company where it is carried out.

Consequently, it is necessary to implement it when already having clear aims, conception of restructuring, understanding of all its phases and methods for necessary actions.

It is possible to divide restructuring into two main kinds. The strategic restructuring is intended to increase the value of equity, keep the corporate property and deal with other

issues for the firm to maintain its functional condition. The restructuring of companies is focused on the restructuring solutions for insolvent or bankrupt enterprises to lead them back in the suitable condition of enterprise. In the circumstances of Latvia the most interesting aims, principles and techniques are those relating to the restructuring of business experiencing a situation of crisis.

Generally, there are three stages in the development of crisis situation.

The early stage is characterized by the occasional signs of insufficiency in production and sales, appearing as increase in stocks of goods and materials, when the rate of rise in the volume of sales is stable or decreasing, acceleration of credit turnover and problems regarding to delivery or quality of production.

Shortage of materials (as a result of steps taken to economize the financial resources by reducing the stocks of goods and materials), more frequent problems regarding to the quality of production, suspension of sales using credit and demands for cash payments by suppliers, overdue payment of wages – this all is what marks for the intermediate stage.

At the last stages of the crisis whole company is operating chaotically. Schedules of production are not being carried out; production is being often sent back because of poor quality or obstructed by chronic shortage of materials; period for repayment of debtor's debts is increasing. Besides, suppliers are demanding cash payments, while creditors are demanding changed terms of credit. Finally, it is becoming apparent that company is seriously short of own current assets.

The situation of crisis can be described as not enough effective management of assets and debts to creditors, determining drain of financial means away from owners and leading at the end to what are not completely fulfilled demands of creditors.

One of the main ends of restructuring is to lead company out of a crisis. In addition it is necessary of all its phases and methods for necessary actions. To achieve subordinate aims, such as to increase production effectiveness, change character of assets management and apply opportunities of borrowed funds (1).

The selling of portions of the company, such as a division that is no longer profitable or which has distracted management from its core business, can greatly improve the company's balance sheet. Staff reductions are often accomplished partly through the selling or closing of unprofitable portions of the company and partly by consolidating or outsourcing parts of the company that perform redundant functions (such as payroll, human resources, and training) left over from old acquisitions that were never fully integrated into the parent organization.

Other characteristics of restructuring can include:

- Changes in corporate management (usually with golden parachutes)
- Sale of underutilized assets, such as patents or brands
- Outsourcing of operations such as payroll and technical support to a more efficient third party
- Moving of operations such as manufacturing to lower-cost locations
- Reorganization of functions such as sales, marketing, and distribution
- Renegotiation of labor contracts to reduce overhead
- Refinancing of corporate debt to reduce interest payments
- A major public relations campaign to reposition the company with consumers

## **2. Levels of a company restructuring**

How to restructure a company? This question is still opened. There is more than one way of company's restructuring. Moreover, even the sequence of the levels of restructuring may substantially vary depending on the situation of the company, its potential, position in the market, behavior of the competitors, descriptions of the producible goods and services and many other factors.

Following basic principles of the method of projects management can mark out few levels of projects marketing restructuring

**First level** – determination the aims of restructuring. Owners and management have to define what exactly does not satisfy them in a current activity of the company and what do they want to obtain in a result of the structural changes. Further development of company and restructuring programs fate depends on how correctly they will define the aims and the range of the tasks.

**Second level** – diagnostics of the company. It is necessary to find company's problems, to define its weak and strong sides, to understand the prospects of development and profitability of the further investing in this business. During the diagnostics of company, a legal, tax analysis, analysis of operating activity, market and investment attractiveness of the company is carried out. Its financial state, strategy and activity of administration also have to be studied.

**Third level** - restructuring programme. There are made a few alternative variants of company development at this level as a result of data diagnostics. For every variant the methods of restructuring are determined, the indexes of prognoses are calculated, possible risks and amount of the used resources are appraised. On the basis of different criteria, the owners and management of company conduct the estimation of efficiency to one or another alternative and carry out choice, according to which the restructuring program is taking into consideration the limitations of the resources, are specified.

**Fourth level** – realization of restructuring according to the developed program. A team of specialists, which are involved in the work, is being formed. This is followed by the sequential implementation of all the levels of the program. During conducting the fourth level of restructuring, purpose indexes are specified and, if there is a deviation from their planned values, a company carries out an adjustment of the program.

Finally the **fifth level** – maintenance of the restructuring program and estimation of its results. At the last level the team, which is responsible for realization of the program, controls the accomplishment of purpose indexes, analyses received results and prepares total report of the work that has been done.

### **3. Company's strategy and restructuring aims**

To carry out above-mentioned levels successfully, it is necessary to formulate restructuring aims correctly. They are determined, coming from the general strategy of the company. In a management terminology: the strategy is a general direction of the company's actions, following which in a prospect have to take to planned aims.

The process of choosing strategy takes place after ascertainment of company's current strategy and accomplishment of a careful analysis of products briefcase. The last action is one of the major instruments of strategic management. In fact the analysis of a briefcase allows balancing the business risks, its money receipts, which as a result increase shared financial return.

In the conditions of the economy of Latvia the competent analysis of business-case with a subsequent elaboration of restructuring program can substantially improve position of a company and in many times promote its value. Such effect can be explained that Latvian companies business-cases is not well organized now and surplus diversified, cause too much questions for investors, and, as a result, underestimated.

A company that has been restructured effectively will generally be leaner, more efficient, better organized, and better focused on its core business. If the restructured company was a leverage acquisition, the parent company will likely resell it at a profit when the restructuring has proven successful.

The most important indicator relating to the productivity of business activity is increase in the value of equity; therefore the restructuring usually is realized towards this direction. The choice to take the indicator of company's value as a criterion for restructuring is not unintentional. After all, a kind and technology of production, parameters of products and sale markets are not of great importance for owners. The criterion for productivity of their financial contributions in a particular company is a steady increase in the value of investments, determining a rise in personal prosperity of owners, as well as stable development of the enterprise.

The value of company is defined by evaluation of business (operating enterprise). Out of three traditional approaches to the evaluation, merely the method of discounted cash flow, as we suggest, completely reflects internal economical value of company. It is determined by a high correlation of cash flow to indicators of the company's market value, as well as by economical meaning of the cash flow indicator taking into account all decisions linked with company's operational and financial activity, as well as that of investments (2).

Indicator of enterprise's value, determined by the method of discounted cash flow, consists of cash flow, added to a current value, from a period of enterprise's stabilization (period of calculation) and developed. Thus, strategic aims of the enterprise are formulated and specified, high quality and quantitative purpose parameters, which the system has to reach, discounted value of cash flow beyond the period of calculation.

Business value obtained by the method of discounted cash flow often turns out to be a negative number, which in fact means that funds are draining away from shareholders. It is caused by consequences of crisis situation, such as chronic shortage of own current assets, necessity to repay significant liabilities, increased or decreased need for investments as a result of multiple unregulated reappraisals of basic funds for depreciation deductions. Traditional task of business restructuring is to maximize the value of business.

Restructuring of company is to change company's structure (or, in other words, organization, arrangement of its elements), as well as elements forming its business under influence of factors of external or internal environment. Restructuring includes: improvement in management system, financial economical policy of company, its operational activity, system of marketing and sale, personnel management.

The main reason for companies to carry out restructuring is a low productiveness of their activity, appearing through unsatisfactory financial indicators, shortage of current assets, and high amount of liabilities of debtors or debts to creditors (3).

However, as any modification influencing scale of business or market conditions demands adequately changed management system and program of restructuring to be carried out, even successful companies are often running structural transformations.

Defined aims and strategy of company will determine one certain type of restructuring: operational or strategic.

The operational restructuring includes transformation of company's structure, aimed to financial recovery (if the company experiences situation of crisis) or improvement in solvency. It is carried out by applying internal resources of company through the instruments of decreasing and "aligning" (a transition from indirect costs to direct ones) expenses, separating and selling unprofiled and auxiliary businesses. The result of the operational restructuring is a transparent and more manageable company, with managers and owners being clearly aware of the businesses to be developed and those to get free from. The operational restructuring encourages improvements in results of business activity in the short term and creates conditions for further, strategic restructuring to be carried out.

The strategic restructuring is a process of structural transformations intended to improve the appeal of company in the eyes of investors and expand its opportunities in attracting external financing and increase in value. Implementation of this sort of restructuring is

directed towards achievement of long-term aims. The result of successful completion of the restructuring is increased flow of the current value of forthcoming incomes, increase in competitiveness of company and market value of its equity. Carrying out both operational and strategic restructuring may encompass either all elements of business-system or its separate components.

Methods of business restructuring to prevent bankruptcy of enterprise and improve its financial position are frequently applied in developed countries. A characteristic feature of rather new Latvian market is that financing methods and organization, as well as cash flow management, used by most of small and average businesses, are not rational. The financial instability causes high rate of bankruptcies among new enterprises. The low level of financial management, and inability of financial managers to apply anti-crisis mechanisms in time, rather often is bound up with lack of knowledge specializing in methods and practices of contemporary anti-crisis management.

Important element of anti-crisis management is evaluation of enterprise's financial standing, liquidity, solvency and productiveness of activity, yet it is necessary also to evaluate external and internal factors influencing the financial standing of enterprise.

Research of the financial standing of business activity in order to detect, as soon as possible, signs of business crisis, causing threat of bankruptcy, is a part of the common financial analysis. In the same time this part of the financial analysis has distinctions in relation to both objects and methods to carry it out.

Those objects of observation within the possible crisis area that may suggest threat of bankruptcy are at first the indicators of enterprise's production, investments and flow of recurrent and prospective payments and the indicators of development of net cash flow.

The existing level of threatening bankruptcy is evaluated by the absolute liquidity ratio. It gives option to determine extent, to which all the pressing liabilities of enterprise can be implemented by the existing assets of high liquidity within the terms defined by legislature of a particular country. It is unsatisfactory condition for the payments to be ensured if the coefficient is less than 0,2(4).

The level of threatening bankruptcy in future can be determined by two indicators:

- absolute liquidity ratio;
- autonomy ratio.

Evaluation of these indicators is linked with dynamics for several periods. A stable tendency to decreasing level of the ratios suggests suspended threat of bankruptcy at least until the next period. By the absolute value of the ratios it is possible to determine time for the suspended threat to become real (the lower is the absolute value of the ratios, the more inevitable is the threat of enterprise bankruptcy). There are frequent observations in the related literature that optimal value for the absolute liquidity ratio is 0,7, but for the autonomy ratio it is comparable to 0,5, nevertheless distinctions of branch and size of company may significantly affect these average norms.

The following indicators determine capacity to neutralize threat of bankruptcy on the base of company's internal potential:

- Return on assets (ROA);
- Circulation of assets ratio.

The first indicator provides a notion of way the capital invested in funds of company is capable to generate a profit, i.e. to produce additional cash flow to implement a growing amount of payments. Meanwhile the other reflects the rate of additional cash flow to build up, i.e. it works as a multiplier for build-up of company's profit. The foundation of this universal evaluation is the Dupont Pattern.

Methods for integral evaluation of threatening bankruptcy are grounded on a complex analysis of the indicators (which can be supplemented with others, if necessary) given above.

It is the Altman Pattern that is one of the most widespread methods of integral evaluation in the practice of foreign financial management (5).

#### **4. The methods of restructuring.**

When choosing the most appropriate methods to lead company out of a crisis, it is necessary to take into consideration all range of the existing methods for business restructuring.

Business restructuring is structural changes in the area of company's properties, changes in liabilities to creditors, organizational structure of management, increase in labor productivity, reduce in production costs, and thus it is a rising of effectiveness in activity of company and improvement of financial position.

The corporative restructuring embraces broad body of actions, methods and techniques intended to improve financial standing, overcome crisis of company and then to increase the value of company.

Restructuring can be divided in four large directions:

- 1) Merging of companies;
- 2) Division of companies;
- 3) Restructuring of properties;
- 4) Actions, intended to remove financial problems.

Applying outsourcing, i. e. consigning certain works to a subcontractor provides an option to form virtual corporations. Usually virtual corporations are formed on a base of large, well-known brand holders when they found a sort of alliance with subcontractors and commit to them as much functions as possible (up to production), meanwhile themselves dealing only with an advancement of production in market, advertisement, marketing, technical scientific and design development, strategic planning and like. A transition to a virtual corporation provides additional flexibility in the risk management and rising of the financial stability, as all new trends of development are not linked with large investments in those business areas that are committed to subcontractors, thus decreasing risk of bankruptcy.

One of the methods for business restructuring relates to property of company. A characteristic example for this method can be a privatization. In this case privatization is not a transfer of state-owned property to private hands but rather a transition of public company with shares belonging to a large number of shareholders in private ownership, with a small group of investors (often managers of company) buying the shares. Such actions may be intended to decrease costs necessary in servicing a large number of shareholders, to prevent contradictions between shareholders and managers about issues relating to long-term business planning, and to lead company out of crisis situation. Mechanism of privatization resembles that of joining and it is carried out, buying shares not only by means of group of individuals but also by leveraged buyout, as it is frequently practiced. It gives option for investors to suspend huge costs and Purchase Company even when not having a considerable capital.

However the main aims of business restructuring, rather important aspect of restructuring process is to gain additional effect of synergy. For example, in the case of merger the direct effect of synergy is that a value of merged company is higher then a sum of its separate parts; in the case of division works the inverse effect of synergy – value of remained parts of firm after selling or separating is higher then difference between initial value of firm and sold subdivision.

One of frequently practiced variations of business restructuring to overcome crisis of company and obtain effect of synergy is to divide assets of company, applying various ways: for example, selling, spinning-off assets and a subdivision, spinning-off a part of equity and others, up to liquidating a separate enterprise of company. The crucial condition for a partial sale of shares or sale of whole company (voluntary liquidation) is whether the reduced net

value of sold assets will be higher than that of anticipated cash flow in the case of further application of the assets. This condition is becoming stronger especially after announcement about voluntary liquidation of company.

Spin-off, i. e. giving away part of assets when a branch or subsidiary is separated from main company, gaining self-dependence, somehow resembles sale of assets, but obtained synergy is not so clearly distinctive in terms of value because process of spin-off is bound up with huge costs. However, it is often the way companies overcome crisis, as well as avoid taxes due to sale of stocks, while subdivisions, when becoming self-dependant, gain additional flexibility in their financial management, option to choose organizational structure for their management, option to conclude new contracts, etc. When it is about division of properties, usually it is never carried out in practice as shares of the new company are divided between shareholders of subsidiary adequately to the existing proportion.

Spinning-off a part of equity somehow differs from the method given above, besides a part of common shares of subsidiary is sold in public sale while a parent company holds the majority interest. This procedure makes it possible to attract additional means to finance separate business trends and overcome financial problems, moreover subsidiary, when gaining independency in share quotation, becomes more appealing to investors.

Complicatedness of actions to prevent the financial problems depends on the level of difficulty inherent in the problems, from insolvency to financial crash. A string of actions to prevent the problems is included in arrangements, voluntary concluded with creditors to delay repayments, on compromises between debtors and creditors, by which creditors agree that a part of debts is discharged by money, receiving a remaining part by a common bill of exchange. Besides it is possible to reach an agreement with creditors on the voluntary liquidation, even before the company is acknowledged to be bankrupt.

It is the actions aimed to reorganization of company that will be most effective to overcome a crisis of company. The reorganization envisages changes in the capital structure of company experiencing financial difficulties. It is intended to decrease fixed costs, i. e. to decrease the part of securities with fixed expenses and increase the part of securities with limited income. It is always useful to carry out reorganization when it may increase the value of company in comparison with the value of liquidity. The reorganization must take place in line with a well-founded, objective and suitable reorganization plan (6).

In general any reorganization is a process bounded with analyzing the means and financial sources of company, evaluating the existing standing of company, detecting the factors that cause worsening financial standing, drafting a plan of actions to overcome a crisis of company. It is the effectiveness of management methods that is analyzed by evaluating increase in financial stability and profitability of activity of separate subdivisions and whole company, and that at the end must increase the market value of company.

The main task for managers and investors is to find those solutions for management of company and overcoming crisis that are most effective and encourage increase in the market value of company. When analyzing and evaluating the effectiveness of a particular method for business restructuring, the main aim is to ground the financial or managerial decision making. Any financial or managerial decision is linked with a degree of uncertainty and risk; therefore it is necessary to take into consideration the influence of internal and external factors on the financial standing and working efficiency of a particular firm, when selecting a method for restructuring.

It is necessary to pay attention to the analysis, evaluation and prognostication of the cash flow, when overcoming a crisis in company. The analysis of the cash flow requires taking into account the income and drain of funds, evaluating not only the net profit, but also other indicators, such as solvency, liquidity, depreciation deductions, and flow of labor capital. The cash flow management determines its influence on the volume of sale, production costs,

relation between constant capital and variable capital, prime cost of realizable production and gross profit.

The adopted method for restructuring can be considered as a variation of investment with the initial expenses and forthcoming profit in future; therefore it is necessary to discount the cash flow, when calculating the possible value of company after the completed restructuring. Evaluation of the adopted restructuring method is to make prognostication of the net cash flow characterizing the current standing of company, ignoring the expenses of restructuring.

## 5. Conclusions

In the light of all stated above it is necessary to pay attention to:

1. When prognosticating and planning the activity of firm, its management must take into account the opportunities of restructuring to prevent crisis in company;
2. In the situation of crisis the financial economists of company must evaluate all the possible variations to overcome crisis, including methods of restructuring;
3. As the restructuring process is regulated in many respects by the normative acts frequently being altered, it is of necessity to carry out constantly the monitoring of juridical collateral.
4. For the time being the international practice and experience of restructuring suggests that it is one of the most difficult managerial tasks. Restructuring is not a single transformation in the structure of capital or production. It is a process demanding an account of many restrictions and peculiarity of the company where it is carried out. Consequently, it is necessary to implement it when already having clear aims, conception of restructuring,
5. Restructuring of company is to change company's structure (or, in other words, organization, arrangement of its elements), as well as elements forming its business under influence of factors of external or internal environment.
6. Restructuring includes: improvement in management system, financial economical policy of company, its operational activity, system of marketing and sale, personnel management.
7. The effect of the restructuring process can be measured using business evaluation methods according firm existing financial statement.
8. It is necessary to take into account statistical data from the developed countries, when evaluating possible methods to overcome crisis of company.

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