MBF1223 | Financial Management

Prepared by Dr Khairul Anuar

L9 - Financial Distress

1. Financial Distress

Definition of Financial Distress

- Financial distress is a situation where a firm's operating cash flows are not sufficient to satisfy current obligations (such as trade credits or interest expenses), and the firm is forced to take corrective action.

- Financial distress may lead a firm to default on a contract, and it may involve financial restructuring between the firm, its creditors, and its equity investors. Usually the firm is forced to take actions that it would not have taken if it had sufficient cash flow.

1. Financial Distress

Definition of Financial Distress

- The definition of financial distress can be expanded somewhat by linking it to insolvency.

- Insolvency is defined as inability to pay one's debts; lack of means of paying one's debts.

1. Financial Distress

- A firm that does not generate enough cash flow to make a **contractually required payment**, such as an interest payment, will experience financial distress.

- A firm that defaults on a required payment may be forced to liquidate its assets.

- More often, a defaulting firm will reorganize its financial structure. Financial restructuring involves replacing old financial claims with new ones, and takes place with private workouts or legal bankruptcy.

- Private workouts are voluntary arrangements to restructure a company's debt, such as postponing a payment or reducing the size of the payment. If a private workout is not possible, formal bankruptcy is usually required.

2. The 11 Largest Bankruptcies In American History

Company	Filed Chapter 11:	Value at bankruptcy
Pacific Gas & Electric Co	2001	$36.15 billion
Thornburg Mortgage	May 2009	$36.5 billion
Chrysler	April 2009	$39.3 billion
MF Global	October 2011	$41 billion
Conseco	2002	$61.4 billion
Enron	2001	$65.5 billion
CIT Group	November 2009	$80.4 billion
General Motors	June 2009	$91 billion
WorldCom	July 2002	$103.9 billion
Washington Mutual	September 2008	$327.9 billion
Lehman Brothers	September 2008	$691 billion

- Effect of bankruptcies not only on shareholders but also other stakeholders
- In some cases the government may decide a liquidation will have wider repercussions (eg, General Motors and Chrysler, Lockheed and Douglas Aircraft)

3. Issues Facing a Firm in Financial Distress

- Financial distress begins when a firm is unable to meet scheduled payments or when cash flow projections indicate that it will soon be unable to do so. As the situation develops, five central issues arise.

1. Is the firm's inability to meet scheduled debt payments a temporary cash flow problem, or is it a permanent problem caused by asset values having fallen below debt obligations? (Refer Slide 25)

2. If the problem is a temporary one, then an agreement with creditors that gives the firm time to recover and to satisfy everyone may be worked out. However, if basic long-run asset values have truly declined, then economic losses have occurred. In this event, who should bear the losses, and who should get whatever value remains?

3. Issues Facing a Firm in Financial Distress

3. Is the company "worth more dead than alive"? That is, would the business be more valuable if it were liquidated and sold off in pieces or if it were maintained and continued in operation?

4. Should the firm file for protection under Chapter 11 of the Bankruptcy Act, or should it try to use informal procedures? (Both reorganization and liquidation can be accomplished either informally or under the direction of a bankruptcy court.) (Refer Slide 25)

5. Who should control the firm while it is being liquidated or rehabilitated? Should the existing management be left in charge, or should a trustee be placed in charge of operations?

3. Value-Based versus Flow-Based Solvency

- The definition of financial distress has two general themes: value and flows.

  - **Value-based insolvency** occurs when a firm has negative net worth, so the value of assets is less than the value of its debts.

  - **Flow-based insolvency** occurs when operating cash flow is insufficient to meet current obligations. Flow-based insolvency refers to the inability to pay one's debts.

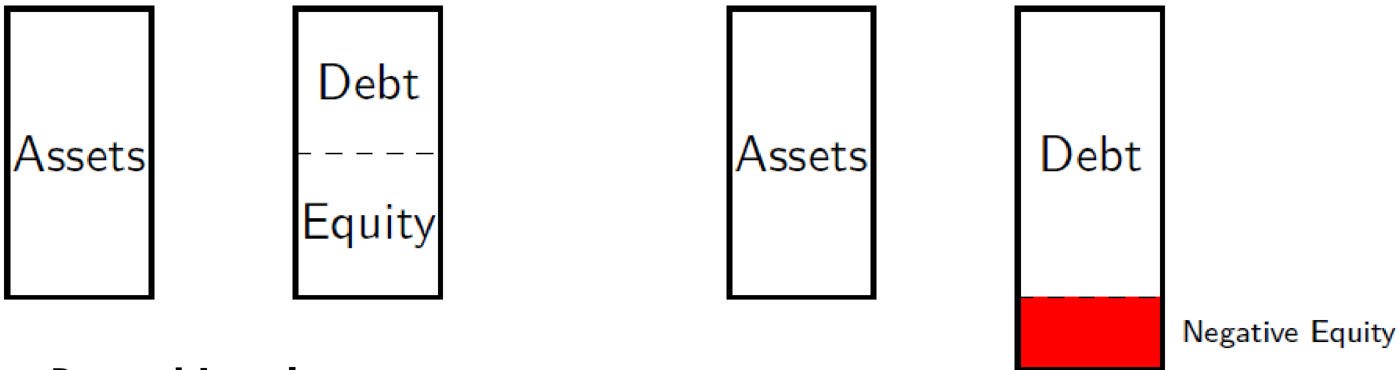
- These two ways of thinking about insolvency are depicted in the following slide.

3. Value-Based versus Flow-Based Solvency

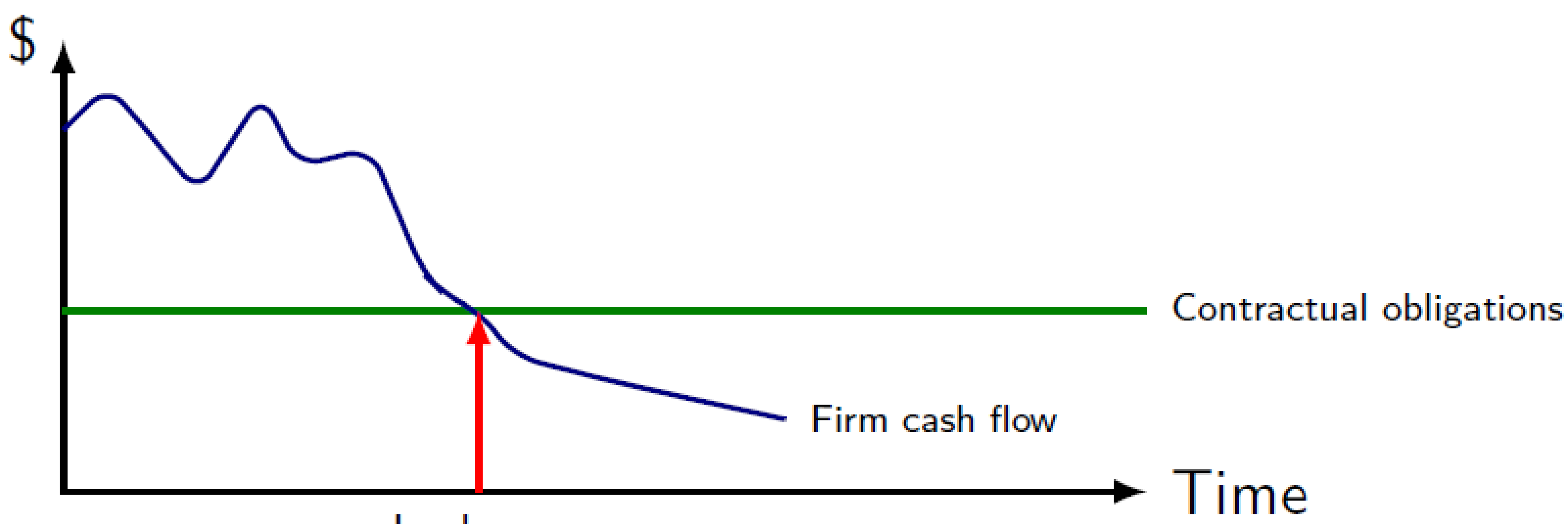
Stock- Based Insolvency

Solvent Firm

Insolvent Firm



Flow- Based Insolvency



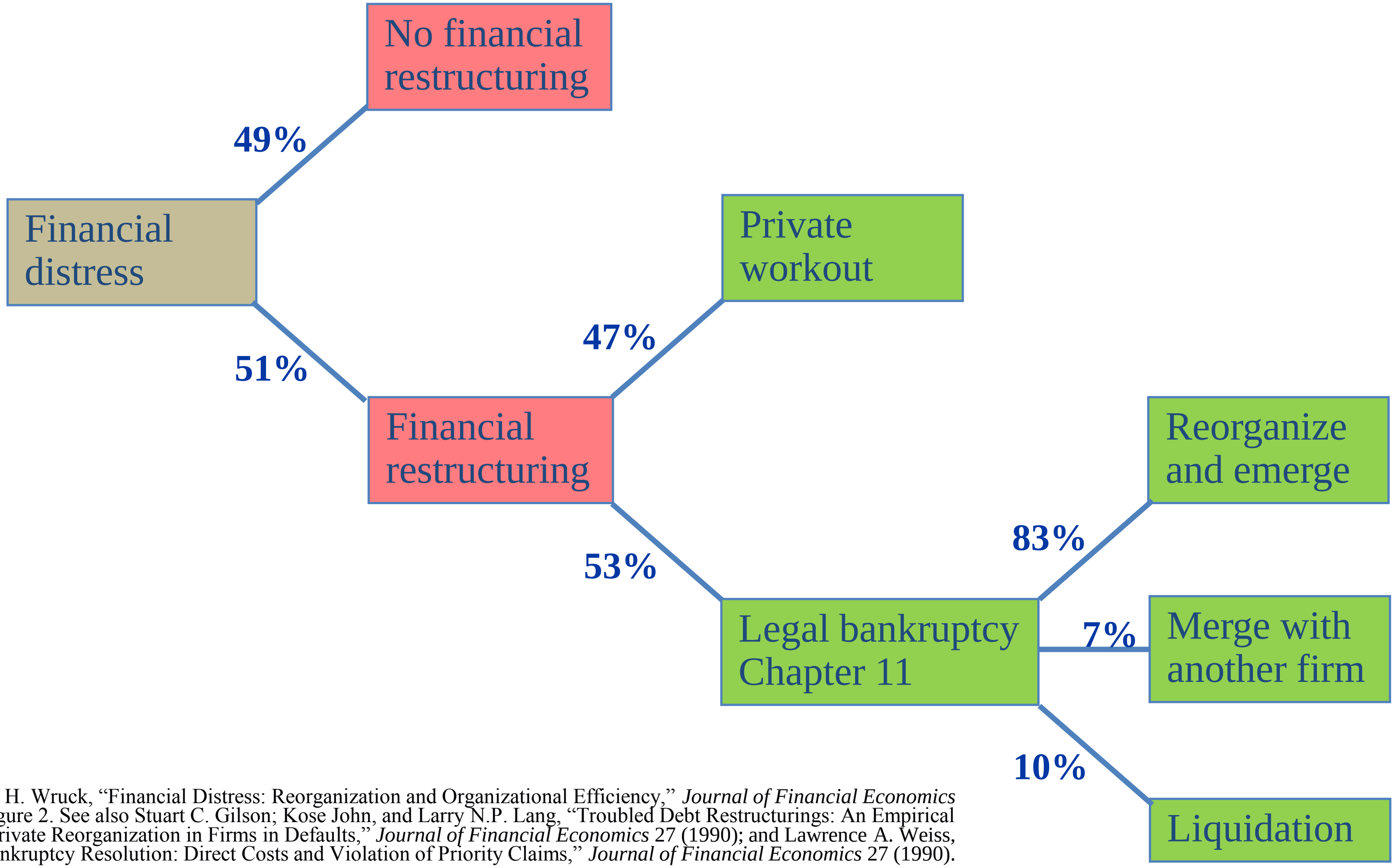
4. What Happens in Financial Distress?

- There are many responses to financial distress that a firm can make.

- These include one or more of the following turnaround strategies.

  1. Asset expansion policies
  2. Operational contraction policies
  3. Financial policies
  4. External control activity
  5. Changes in managerial control
  6. Wind up company

4. What Happens in Financial Distress



Source: Karen H. Wruck, "Financial Distress: Reorganization and Organizational Efficiency," *Journal of Financial Economics* 27 (1990), Figure 2. See also Stuart C. Gilson; Kose John, and Larry N.P. Lang, "Troubled Debt Restructurings: An Empirical Study of Private Reorganization in Firms in Defaults," *Journal of Financial Economics* 27 (1990); and Lawrence A. Weiss, "Bankruptcy Resolution: Direct Costs and Violation of Priority Claims," *Journal of Financial Economics* 27 (1990).

5. Responses to Financial Distress

<u>Think of the two sides of the balance sheet.</u>

- **Asset Restructuring:**
  - Selling major assets.
  - Merging with another firm.
  - Reducing capital spending and R&D spending.

- **Financial Restructuring:**
  - Issuing new securities.
  - Negotiating with banks and other creditors.
  - Exchanging debt for equity.
  - Filing for bankruptcy.

5. What Happens in Financial Distress?

1. Asset Expansion Policies

- If a firm finds itself in difficulty, it may try to reduce the risk of its operations by increasing the size of its business or assets. Asset expansion policies include the full acquisition of another firm, a partial acquisition, setting up a new joint venture, increasing capital expenditure, higher levels of production, or expansion of existing facilities.

- The joint venture between Fiat and Chrysler is a good example of an asset expansion policy. In 2009 carmakers were facing a bleak prospect, with sales down across the world. The US and British governments had already bailed out their own automobile industries, and many carmakers had reduced production to only part of the year. By entering into a joint venture, Fiat and Chrysler were able to expand their sales revenue at a time when they needed it the most.

5. What Happens in Financial Distress?

2. Operational Contraction Policies

- The opposite of expansion is contraction, and many firms choose to focus on their most profitable businesses during a downturn.

- Operational contraction policies include asset sales, spin-offs and divestitures. Plants may also be closed, production can be cut, and employees made redundant.

- Honda is a good example of following a contraction policy. First quarter results for 2009 were absolutely dire. Car sales had dropped by 10 per cent, compared to the same period in 2008. There was also the very strong possibility that the company would make an annual loss for the first time since it was founded in 1948. In response, Honda cut global production by 420,000 units and closed its UK plant for four months in order to reduce inventory levels. The employees of the British plant were still paid during this period and, as a result, no redundancies were made.

5. What Happens in Financial Distress?

3. Financial Policies

- Financially distressed firms will definitely face some type of cash liquidity problem. Several remedies are available. One, the company can reduce its annual dividend. Another option is to restructure existing debt facilities so that less interest is paid. The equity and debt markets may also be tapped to raise further funding.
- During the global credit crunch many banks had to be bailed out by their governments with loan guarantees and equity share issues. In addition, almost every bank slashed its dividends to zero.

5. What Happens in Financial Distress?

<u>4. External Control Activity</u>

- External control activity means that the firm has been taken over, or an outside investor takes a significant stake in the firm. A change in external control means that one or more major share-holders sell their shares to another investor with a larger capital base and greater access to capital.

- The European football industry has seen many deals of this type. One notable example is Glasgow Celtic, which was days away from bankruptcy when investor Fergus McCann purchased the shares of the club, imposed a very strict turnaround strategy, and reduced debt to almost zero. The team subsequently went on to dominate Scottish football, reached the UEFA cup final in 2003, and was one of only a few major British clubs to make a profit during the economic recession.

5. What Happens in Financial Distress?

5. Changes in Managerial Control

- The ultimate penalty for poor performance is losing your job, and many firms opt to remove their chairman, chief executive or other directors when they are in financial distress. This will normally go hand in hand with other forms of restructuring.

- Examples include Fred Goodwin, the former chief executive of Royal Bank of Scotland, who had to step down after the bank found itself in serious financial difficulty as a result of the acquisition of Dutch bank ABN AMRO in 2007.

5. What Happens in Financial Distress?

6. Wind up Company

- The final and least desirable strategy a financially distressed firm will follow is to wind up its operations and go into some form of bankruptcy.

- Bankruptcy laws differ on a country-by-country basis. Bankruptcy may not always end in the disappearance of a company, and firms may be split up, sold on to a new buyer, or restructured during the process.

6. Bankruptcy Liquidation and Reorganization

- Firms that cannot or choose not to make contractually required payments to creditors have two basic options: liquidation or reorganization.

  - **Liquidation** means termination of the firm as a going concern. It involves selling the assets of the firm for salvage value. The proceeds, net of transactions costs, are distributed to creditors in order of established priority.

  - **Reorganization** is the option of keeping the firm as a going concern; it sometimes involves issuing new securities to replace old securities.

- Liquidation and formal reorganization may be done by bankruptcy.
  - Bankruptcy is a legal proceeding, and can be done voluntarily, with the corporation filing the petition, or involuntarily, with the creditors filing the petition.

7. Private Workout or Bankruptcy?

- A firm that defaults on its debt payments will need to restructure its financial claims.

- The firm will have two choices: **formal bankruptcy or private workout**.

- Both types of financial restructuring involve exchanging new financial claims for old financial claims. Usually senior debt is replaced with junior debt, and debt is replaced with equity.

7. Private Workout or Bankruptcy?

- Much recent academic research has described what happens in private workouts and formal bankruptcies.
  - Historically, half of financial restructurings have been private, but recently formal bankruptcy has dominated.
  - Firms that emerge from private workouts experience share price increases that are much greater than those for firms emerging from formal bankruptcies.
  - The direct costs of private workouts are much less than the costs of formal bankruptcies.
  - Top management usually loses pay and sometimes jobs in both private workouts and formal bankruptcies.
  - These facts, when taken together, seem to suggest that a private workout is much better than a formal bankruptcy. We then ask: Why do firms ever use formal bankruptcies to restructure?

8. Straight Liquidation: Chapter 7

Chapter 7 of The Federal Bankruptcy Reform Act (1978)

- Chapter 7 details the procedures to be followed when liquidating a firm;
- Chapter 7 does not come into play unless it has been determined that reorganization under Chapter 11 is not feasible.
- Once a firm files for Chapter 7, the bankruptcy court judge appoints a trustee to oversee the process of liquidation, the order of which is as set out next slide.

- Chapter 9 deals with financially distressed municipalities;
- Chapter 12 covers special procedures for family-owned farms;
- Chapter 13 covers the adjustment of debts for "individuals with regular income"; and
- Chapter 15 sets up a system of trustees who help administer proceedings under the act.

8. Straight Liquidation: Chapter 7

1. Proceeds from the sale of the collateralized assets or transfer of actual assets to secured creditors to settle their claims
2. The trustee's expenses in administering the sale of assets and payment of claims
3. Payment to claimants whose claims result from activities after the filing of Chapter 7
4. Wage earners of the company for unpaid wages (there are limits for this class of claims)
5. Claims for unpaid portions of benefit plans for employees (again, there are limits for this class of claims)
6. Unsecured claims from customer deposits (up to a certain amount)
7. Federal, state, and local unpaid taxes
8. Unfunded pension plans
9. General unsecured creditors (unsecured bank loans, bondholders, and so forth)
10. Preferred stockholders up to the par value of their stock
11. Common stockholders (all remaining funds)

Note that common stockholders are last on the list and typically get little to nothing of the proceeds from the sale of the remaining assets.

9. Reorganization: Chapter 11

Is what some firms file for if their managers feel that there is a chance that they could re-structure the firm and be worth more alive than dead. In a typical re-organization the process is as follows:

1. A petition for Chapter 11 is filed by either the company or by a creditor, and a bankruptcy court judge either accepts or denies the petition.

2. If accepted, a date is set by the judge for all claimants to show proof of their claims.

3. A reorganization plan is presented to the court and must be approved by a majority of the members of a claimant class.

4. If the claimants cannot agree on the reorganization plan, the judge may issue a ruling on all or parts of a plan and thus "decree" the reorganization plan.

9. Reorganization: Chapter 11

5. If a minority of classes does not agree to the plan, the judge may listen to their objections and alter the reorganization plan.

6. Often, the current managers continue to run the business while it operates under the reorganization plan, but the court may also appoint a trustee to oversee the operations and protect the rights of the claimants during this period of time.

7. The reorganization plan may allow the issuance of new securities and thus add another set of claimants to the firm.

8. Old debt may be restructured in terms of both maturity and rates.
9. The plan itself holds off claimants while the company tries to reorganize and come out of bankruptcy as a new operating firm.

10. If a firm fails to make the reorganization plan work, it will probably fall into Chapter 7 bankruptcy.