Corporate Financial Distress

Restructuring and Turnaround

Alberto Tron

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Corporate Financial Distress: Restructuring and Turnaround

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Preface

This book aims to provide an overview of the ongoing academic debate about corporate financial distress and how academics, experts and business managers approach it both at the international level and in the Italian context. In particular, five main areas have been investigated.

In the first chapter, we offer a complete and in-depth analysis of corporate financial distress, bankruptcy and recovery turnarounds as the current academic debate updates existing literature and provides new materials to highlight. As is generally known, research on financial distress and corporate crisis management is relatively recent if compared to studies on financially sound enterprises.The corporate health of firms is of considerable concern for various stakeholders, such as investors, managers, policymakers and industry actors. Nowadays, the main concern of companies, regardless of their size and sector, is the threat of insolvency, and this emphasises the relevance of preventing and mitigating a corporate downturn.

Both academics and professionals have contributed substantially to crisis literature: professionals and managers generally focus on *how to* procedures and techniques while academics and scholars address more *theory-based response strategies*, including the corporate apologetic approach, financial distress prediction, image restoration or specialised fields such as product-harm crises.

In this chapter, the importance of financial equilibrium is analysed. In recent decades, finance gained more and more relevance and now it has a strategic role in company governance. Today, finance is not only related to the other company sectors through its influence on their choices and their operating processes, but it also determines new strategies and new business models.

In the second chapter, the adopted perspective – specifically focused on the going concern evaluation – outlines the path of business value protection achieved by turnaround management. The starting assumption is that no crisis is intrinsically unrecoverable: the problem is not the existence of a solution to the crisis itself, but rather the economic convenience and willingness (of the actors involved in the recovery process) to provide the necessary means for the successful achievement of equilibrium conditions. The suitable tools to solve a corporate crisis have to reconcile the efficiency principle (and, therefore, the lower cost of management) and that of equity (that is, the maximum satisfaction of stakeholders) to avoid failure.

For the negotiation of the crisis business plan, the restructuring or industrial/strategic turnaround assumes a role of absolute pre-eminence over any considerations of a financial and corporate nature. The entrepreneur is required to draw up an adequate and consistent turnaround plan, or reorganisation. The plan represents the essential tool to evaluate the technical and economic feasibility of the overall recovery project. A document drawn up in 2017 by the National Council of Chartered Accountants and Accounting Experts (CNDCEC with AIDEA-ANDAF-APRI-OCRI) entitled *Guidelines for the preparation of the Recovery Business Plan* (hereafter *Principi*) highlights how the basic aim is to rationalise and plan the business choices and summarise them in a complete document, which should be representative and easily readable. If the Recovery Business Plan (hereafter 'RBP') respects the principle of clarity, the recipient will immediately understand the business idea underlying it, the subsequent objectives, the tools and solutions to achieve it and the resources to be used.

In the third part, we point out that a successful financial restructuring plan requires careful planning of the interventions deemed necessary to solve the crisis, and the punctual identification of the related timing. The time component, in particular, represents a constraint the scope of which is frequently underestimated as the company faces a crisis situation. Research into execution, monitoring and performance is described here; as the recovery plan implies the pursuit of a specific strategy, it is necessary to prepare an organisational structure to support the strategy implementation. The literature has largely focused on the strong links between strategies and structures. The key elements of a performing organisational model are seemingly conceptual but, as a matter of fact, they have strong features of concreteness and measurability which are necessary to assess any possible deviations between the planned objectives and the results which are achieved as we proceed with the recovery. The analysis of the deviations is fundamental to prepare the suitable corrective actions during the implementation of the recovery project. In order to minimise the risk of a possible inadequate implementation, the best practice principles provide for a specific deployment and monitoring phase to mitigate any unexpected unsatisfactory under-performance, which, in some cases, could undermine the success of the recovery operation.

In the fourth section, empirical research carried out in Italy underlines the common characteristics of firms under financial distress and the possible prediction of bankruptcy or recovery. In a research study carried out in 2012 by the University of Pisa in collaboration with ANDAF (Associazione Nazionale Direttori Amministratori Finanziari – Italian Financial Executives Association), on a sample of 52 industrial and service companies featuring the worst performance listed on the Italian Stock Exchange (Borsa Italiana S.p.A.), an attempt was made to test if the financial flows could provide valid information on their future economic performance. The above-mentioned research was applied in 2013 to the same sample of companies listed on the Italian Stock Exchange (Borsa Italiana S.p.A.), extending the correlation of financial flows – recorded in the period 2004-2007 – with the average economic performance values of the 2010-2011 period; the correlation values, using Spearman's analysis, as in the 2012 research, were reinforced by the 2013 empirical analyses on the average profitability values recorded in the years 2010–2011. Innovative empirical research by Bocconi University and Parthenope University in 2018 on corporate recovery over a 10-year observation period (2007–2016), in partnership with one of the main national banks, had the objective of investigating the common elements in successful recovery processes, in order to predict the outcome of a certain type of recovery operation and analyse some specific features (whether they were present or not) at the beginning of the restructuring phase. At the end of the chapter, we deal with a recent study (2020) the main objective of which was to contribute to existing research on the predictive ability of cash flows to forecast future cash flows and performance by providing new evidence from the Italian business context, which is significantly under-explored. In order to fill this gap, the ability of cash flows to predict future cash flows was investigated as well as the ability of cash flows to provide decisive investment information both for the individuals inside the organisations and the subjects outside them. The analysis was carried out on a sample of 168 Italian listed companies in the 2008-2017 period.

The final chapter analyses a business case that deals with the strategic and financial restructuring of an industrial group manufacturing products for schools and leisure. The recovery process highlights how, by facing a turnaround process from a strategic point of view, by searching for unexpressed potential within the company system, exploiting industrial and financial synergies and identifying new market opportunities, it is possible to achieve a complete reversal of a situation of imbalance.

The results achieved at the end of the Recovery Business Plan show, in fact, how a reversal trend is possible through specific actions focused on the recovery of profitability and on value creation, and how that progressively affects functions, processes and the whole management. For a successful recovery plan, simple recipes – made up only of staff cuts and/or the dismissal of unprofitable activities (products, segments, consumer groups and geographical areas) – are not enough: an 'organic' recovery needs to be implemented. In the recovery process, the accurate survey carried out at the very beginning of the corporate structure revealed the areas to rapidly act upon, as well as the Group's latent potential and strengths to achieve a successful turnaround. Lastly, it should be noted that the recovery process identified all the responsibilities for each phase of the process, thus allowing the company management to periodically check the correct fulfilment of the actions and monitor the progress towards the desired objectives. The problems regarding the Group's crisis represented the opportunity to achieve a deep internal reorganisation, a targeted cost rationalisation, a debt restructuring and a renewed commercial policy. The turnaround did not focus on resolving the expressive symptoms of the crisis, but aimed at improving the overall management of the company. The turnaround strategy was successful and allowed interesting development opportunities to be taken at the right time even during a difficult period.

The role of time is emphasised throughout the book as an essential variable. The going concern evaluation must be particularly timely if we want to preserve corporate value. And again, time is capital in the restructuring of financially distressed companies as the prolongation of a crisis deeply affects the possibility of any recovery.

Milan, Italy
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Chapter 1

Corporate Distress and Financial Equilibrium: Genesis and Prognosis

1. Introduction and Background

Research on financial distress and corporate crisis management is relatively young in comparison to studies on financially sound enterprises.

The corporate health of firms is of considerable concern for various stakeholders, such as investors, managers, policy makers and industry participants. Nowadays, the main concern of companies, regardless of their size and sector, is the threat of insolvency.

There are several reasons for this strong focus on preventing and mitigating a corporate downturn.

Traditionally, financial economics literature has portrayed financial distress as a costly event, the possibility of which is important in determining firms' optimal capital structure (Opler & Titman, 1994).

A company under financial distress is a company that is struggling with promises made to its creditors. Financial distress can be defined as the point where cash flows are lower than the firm's current obligations (Wruck, 1990).

If a company is unable to meet those obligations, it is in default (Vassalou & Xing, 2004) and its creditors may start legal proceedings to sue for bankruptcy.

This book provides evidence on distressed firms (Chapter 2) from a civil-law country, Italy, that has traditionally been considered a country with rather weak shareholder and quite strong creditor protection (La Porta, Lopez-de-Silanes, Shiefer, & Vishny, 1998).

Most existing studies have so far almost exclusively looked at the US (Altman & Hotchkiss, 2005); however, the US has a financial market that is usually characterised by stronger shareholder and weaker creditor rights if compared to Italy.

Differences in legal regimes are likely to matter for changes in corporate oversight and turnarounds.

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For an Italian company in distress and heading towards default there are three options:

(1) make a deal with creditors, possibly renegotiating obligations.
(2) voluntarily file for bankruptcy, and either be auctioned off as a going concern or liquidated and sold piecemeal.
(3) file for corporate reorganisation at the local district court.

Independently of the local legal regime, this area has become of public concern due to the recent global financial crisis (2008–2009) that witnessed failures of many venerable institutions which were rescued by governments (Bear Stearns, AIG, Fannie Mae & Freddie Mac, Washington Mutual, Anglo Irish Bank, Royal Bank of Scotland, Northern Rock, etc.).

The resolution mechanisms for both the private and public sector use corporate finance paradigms to develop financial distress tools.

Both academics and practitioners have contributed substantially to crisis literature: practitioner–business managers have generally focused on *how to* procedures and techniques (Devlin, 2006; Fink, 1986; Regester & Larkin, 2005; Ruff & Aziz, 2003; Seymour & Moore, 2000;), while academic scholars have tended to address more *theory-based response strategies*, including the corporate apologetic approach (Hearit, 1995, 2006; Outecheva, 2007; Rowland and Jerome, 2004), financial distress prediction (Altman, 1968; Altman, Hatzell, & Peck, 1995; Balcean & Ooghe, 2006; Beaver, 1966; Bose, 2006; Doumpos & Zoupounidis, 1999; Foster, 1986; Kumar & Ravi, 2007; Lin, 2009; Ravisankar, Ravi, & Bose, 2010; Ross, Wesrtefield, & Jaffe, 2010; Sun & Li, 2008), image restoration (Benoit, 1995, 2000; Burns & Bruner, 2000; King, 2006) and post-crisis discourse (Coombs, 2004; Ulmer, Seeger, & Sellnow, 2007) or specialised fields such as product-harm crises (Laufer & Coombs, 2006).

Notable academics have identified and categorised different types of financial distress and corporate crises, in the belief that such categories may help in developing the most appropriate response strategies (Jaques, 2009). Lerbinger (1997), for instance, described seven categories, Coombs (1999) formulated five different ranges, while Gundel (2005) explored in detail the role and properties of crisis types.

Since first devoting its attention to the subject, academic literature has emphasised the difficulties in defining corporate financial distress because of the incomplete and arbitrary nature of any criteria in classifying it (Keasey & Watson, 1987).

There is no general consensus on how financial distress affects corporate performance, but it is costly (Opler & Titman 1994) and needs to be investigated. Altman (1993) relates corporate financial distress to unsuccessful business enterprise and defines four generic terms commonly used in literature which are: failure, insolvency, bankruptcy, and default.

Corporate financial distress remains, nonetheless, a vague term (Altman & Hotchkiss, 2005) that does not correspond to an absolute condition such as bankruptcy or insolvency.

Despite a lack of an exact agreement on crisis definition and typologies, there is at least a reasonable level of commonality. Corporate financial distress identifies a status that is extended in time, embracing the failure path and (both possibly and ultimately) the event of bankruptcy.

According to academic literature, the life of a company is characterised by positive and negative circumstances which, taking place with a certain degree of intensity, determine its economic viability (Alas & Gao, 2010; Cazdyn, 2007; Giacosa & Mazzoleni, 2011; Giannessi, 1982; Onida, 1960).

The crisis is often seen as a recurring event in ordinary corporate life (Bradley, 1978; Gcaza & Urban, 2015; Holmgren & Johansson, 2015; Kadarova, 2010; Kadarova, Markovic & Mihok, 2015; Lagadec, 1991a, 1991b; Pollifroni, 2012; Pollifroni, Militaru & Socaciu, 2014).

During the life of a company, alternation between negative and positive phases may take place either during a temporal phase (or cyclical in time) or it may be a permanent state (Amaduzzi, 1949; Bastia, 1996; Giacosa, 2016; Guatri, 1995; Paolini, 1998; Zanda, 2015; Zappa, 1956).

In a situation characterised by increasingly compressed margins of profitability, the spread of the 2008–09 financial and economic crisis caused difficulty for a lot of medium and medium-large companies to generate sufficient sales volumes to achieve at least a break-even point. Not to mention smaller companies, which found themselves facing a critical situation, without the necessary conditions and resources (not only economic-financial) to deal with it.

Academic literature has essentially been developed in two macro-areas of analysis: (1) the first is represented by studies focusing on the crisis of entire economic systems, productive sectors or geographical areas with clearly identifiable borders; (2) the second area, instead, is represented by works related to the crisis of individual entities (Danovi and Quagli, 2015; Tedeschi-Toschi, 1990).

In scholarship, sectorial crises are explained, in most studies, as a consequence of the specific weakness or physiological evolution of sectors, as well as in terms of the ineffectiveness of public support policies (Boeri, 1985, 1987; Dematté, 1979; Gros-Pietro, 1976; Podestà, 1984; Prodi & Gobbo, 1980).

Within these studies, finally, aspects of a more microeconomic nature begin to assume considerable importance as the real causes of corporate crisis, such as, for example, technological and organisational innovations related to production processes in specific sectors, or consumer behaviour related to the underlying demand trend for specific goods or services.

Negative economic situations, in fact, give rise to an acceleration of processes related to the life cycle of a company, with possible sudden changes from a situation of expansion and growth to a situation of possible contraction and crisis.

Guatri (1995) highlights, from an evolutionary perspective, that the process moving from decline to crisis includes four stages: (1) incubation, characterised by a decrease of economic and financial equilibrium; (2) periodic financial losses are significant and the entity's intrinsic value starts to fall; (3) the mean profitability affects the cash flows and the reduced credibility implies a higher difficulty of borrowing; (4) explosion of the crisis that generates serious impacts at economic, managerial and financial levels, both internally and externally (Pozzoli & Paolone, 2017).

Despite this consideration, through the analysis of case studies, the examination of internal factors as causal factors of corporate crisis seems to be predominant if compared to the study of its environmental dynamics. The literature particularly emphasises the errors made in the strategic and managerial activities of the company (Argenti, 1976; Smart & Vertinsky, 1977).

The relevance of external factors has only been highlighted in recent studies on changes in the political and social environment. Reference is made to contingent and unpredictable events with low probability, such as, for example, natural disasters and accidents at work (Billings, Milburn, & Schaalman, 1980; Lagadec, 1991a, 1991b; Reilly, 1993; Shrivastava, 1992).

An appropriate classification of the reasons that led to the crisis is crucial in order to determine an effective response. The deeper and longer the crisis, the faster and wider the reaction required. In the majority of cases, there is not only one cause for the decline and so consequently the solution is to refer to different areas of intervention.

Grant (2010) states that when the decline is prolonged, the response would likely be both strategic and financial. In this perspective, practice is progressively more oriented to providing models able to predict the phenomenon, and not only to declare its existence (CNDCEC, 2015).

The analysis of a company crisis as commonly described in literature will be carried out in the following paragraphs, starting from balance sheet data and through analysis by indices or flows. The so-called financial analysis is necessary to understand the reasons and genesis of a crisis, as well as to reveal possible solutions.

The following paragraphs introduce the complex phenomenon of corporate financial distress, illustrating its articulation in different phases of the corporate path, reviewing its definition and providing a re-assessment of the relevant academic literature and some guidelines for an optimal corporate financial structure (FS; for the prevention of financial distress).

2. Defining Corporate Distress: From Decline to Crisis

Even if some studies have provided empirical evidence underlining that there is no direct relation between economic and financial distress (Senbet & Seward, 1995; Kahl, 2002a, 2002b), an economic crisis may lead to financial and/or economic distress if contribution from stockholders is missing and if there are no corrective actions. In general terms, distress exists when the company's equilibrium cannot be reached under the current situation. If other actions are not taken, the firm is naturally destined to cease its operations. The concept of 'economic distress' is not very well developed. The literature most commonly refers to this concept by illustrating the aspects related to the above-mentioned economic equilibrium.

The adopted notion of corporate crisis follows a hybrid and contingent approach.

The analysis of the crisis, in fact, as well as the tools and models for its solution, cannot be formalised in a prescriptive and generalised way, as it requires a deep knowledge of the company and of the reference environment in which it operates.

This vision accepts and integrates, according to the systemic theory, the definition of crisis according to the concepts of the Theory of Value (Fruhan, 1979;

Guatri, 1991; Blyth, Friskey, & Rappaport, 1986), dedicating attention also to decline situations, i.e. to phases in which the pathology is still latent in the company structure (Danovi, 2003; Guatri, 1995).

In particular, starting from the fundamental equation of value:

$$W = R/i$$

it is possible to define the concept of the company's decline as the achievement of a negative change in a company's economic value over time; hence the quote 'a company is in decline when it loses value over time'.

The definition of corporate crisis proposed by Guatri, based on the Theory of Value, considers, on the one hand, the awareness that the company will inevitably face moments of crisis during its life cycle and, on the other, the understanding that the crisis may be related to corporate events, but also to changes in the external environment.

Given the fundamental equation of value ($W = R/i$), the crisis is correlated to a negative change in value, highlighting how decline and crisis may depend not only on a decrease in flows (internal events) but also on external events, that is a change in risk conditions (Danovi & Quagli, 2015).

A situation of company decline is not only identified by the presence of economic losses or by a reduction in the related cash flows. To have a decline situation, the economic loss must be systematic and, at the same time, irreversible if no remedial action is taken. The measure of loss should not only be calculated on a final basis but should also refer to prospective flows.

According to Guatri's approach (1995), the crisis path can be described as a sequence of four dependent stages: for each of which, specific events may be observed (see following Fig. 1.1).

Crisis results as a development and worsening of a situation of decline. Often this happens in conjunction with an external or internal trigger event (triggering factor).

There are defined threshold limits for crisis indicators, beyond which the company could find itself needing to undertake a recovery process.

The triggering event has to be considered as a crucial element in the binomial *crisis-recovery* because *in absence of triggering events many companies risk turning into boiled frogs: they act ignoring the growing need for change until they fail* (Tichy & Ulrich, 1984).

According to this approach, the real risk of bankruptcy is just one of the possible forms in which the *trigger event* occurs (Danovi & Quagli, 2015) (see Fig. 1.2).

A situation of financial tension entails recourse to the credit market, with the consequent negotiation of new loans or time extensions.

This happens when the credibility of the company as an economic entity is at stake: the company needs to demonstrate the possible existence of future prospects for development and recovery.

Otherwise, the refusal of credit on the part of the lenders drives the state of financial tension towards a real crisis, which can only be solved through the renegotiation of debt contracts and the opening of a restructuring proceeding. If no major industrial and financial restructuring measures are taken, the insolvency situation is usually irredeemable.

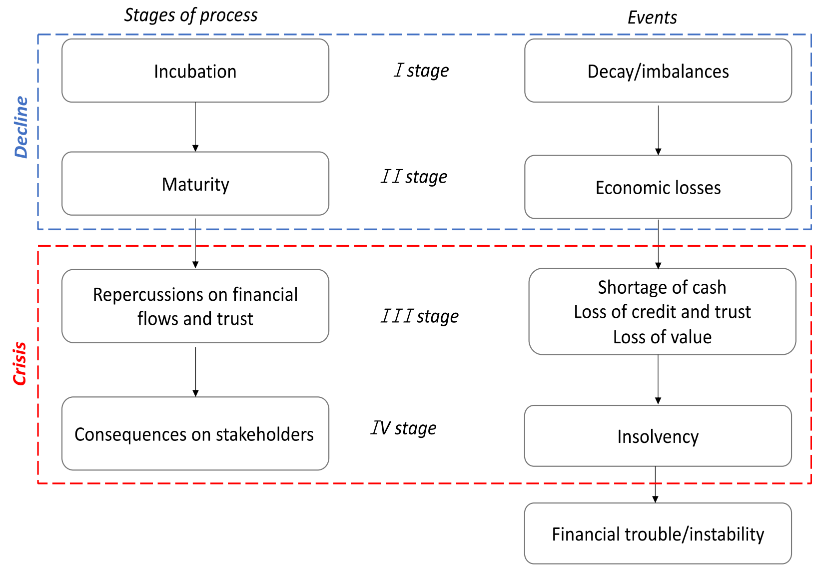

Fig. 1.1. The Four Stages of Crisis according to the Traditional Approach (Guatri, 1995). *Source:* Adapted from Guatri (1995).

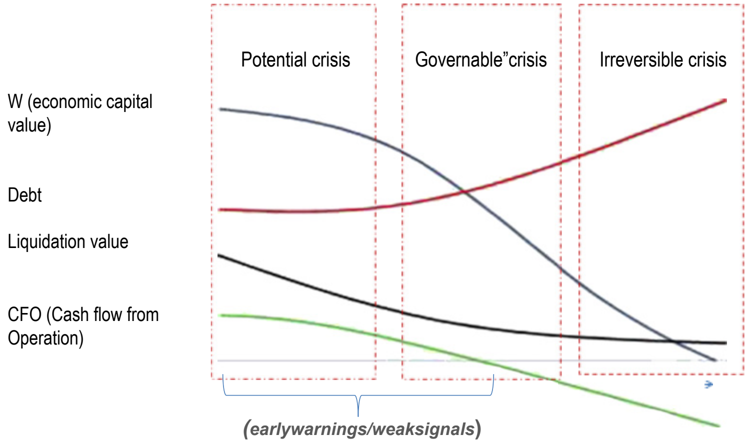

Fig. 1.2. The Path to the Crisis.

Given these concepts concerning crisis and decline, it is possible to propose a definition of recovery, and of restructuring, in terms of 'recovery of value creation'.

The combination of industrial and financial restructuring has often been debated, with reference to the prevalence and/or complementarity between the two phenomena.

This seems to be related to the different visions of crisis, where – from time to time – the emphasis is placed on financial or on industrial aspects. According to the author, there is always the need to look at the crisis with a holistic and organic view, understanding its causes and implementing some integrated recovery policies.

The analysis of the corporate crisis by means of economic-business instruments is essential for an effective and appropriate approach, implementation and verification of the recovery and/or restructuring policies.

It is the continuous monitoring of the data coming from the management that makes it possible to perceive the presence of factors able to interrupt the balance of the company as a whole. Data processing also makes it possible to identify the nature and extent of the imbalance, understand the crisis, or the pathological situation, and to optimally choose the recovery policies and the instruments to adopt.

3. Crisis Factors: Identification, Handling and Governance

As previously mentioned, the causes of the crisis can be multiple or single, latent or sudden, internal or external. It is therefore useful to identify a categorisation that can facilitate its comprehension.

In this book, we will adopt the paradigm which distinguishes if a corporate crisis is either due to an operational and managerial incapacity or to a problem of an economic and financial nature.

Several studies on corporate crises underline the difficulty in interpreting the phenomenon, in terms of effective assessment and presence of causal factors which may be qualified as internal and external to the company. Hence the difficulty in assigning them a specific weight. Studies show that, when analysing a company crisis, due attention must be paid to consideration of the human factor; it was correctly observed that 'a crisis is always the result of a combination of unfavourable events inside and outside the company' (Sciarelli, 1995).

3.1 The Time Factor

Business management, even in a normal situation, inevitably involves a series of small, almost physiological, business imbalances occurring over time (Guatri, 1986). These critical situations do not necessarily lead to obvious disruptions for all stakeholders. It must be said, however, that the company structure is certainly placed under stress by these continuous, albeit small, moments of criticality. But especially in the presence of a shrewd management, it is possible to manage these imbalances and avoid situations of greater instability.

In this view, the so-called company pathologies, normally present in the life of an enterprise, appear externally only when they enter the acute phase (Guatri, 1985). The dynamics of development of a crisis are defined as four widely accepted, distinct and identifiable stages: incubation, manifestation, financial imbalance and explosion (Guatri, 1986).

During the incubation period, the factors of decline generate some signals of imbalance which may be detected through the static and flow indices used in the financial analysis: these data may reveal the critical conditions and growing instability in which the company finds itself. The usefulness of setting up a system of preventive check-ups – with respect to the company crisis situation – is universally recognised and it is mainly based on quantitative analyses of the balance sheet and on the reconstruction of the flows that characterise the company (Amigoni, 1983; Bastia, 1996; Brugger, 1984; Caramiello, 1968; Cavalieri & Ferraris-Franceschi, 2005; Riparbelli, 1950). An effective management control system will allow for a timely identification of critical issues and provide ideas for the areas of intervention.

During the manifestation phase, the loss of income flows and value of the company's assets are explained in the final balance sheet data.

The stages of financial imbalance and explosion make up the real crisis, which may result, as already mentioned, in disruption. Financial imbalance is the external manifestation of the serious moment of difficulty that the company is experiencing, through the income losses highlighted by cash flows and the loss of confidence of the reference environment. The explosion, on the other hand, is the moment when insolvency and possible disruption reach the company's stakeholders.

3.2 Internal Causes

Internal causes of crisis are commonly defined in literature as errors made when defining the company's strategic orientation and/or particular management policies. In this perspective, the distinction between founding crisis and management crisis is worth analysing (Sciarelli, 1995). The former refers to the mistakes made in the structuring of a new company, which starts its activity with weak market positioning and insufficient resources. The second refers to events which occurred during the course of the company's life, and more precisely, to the inability to adapt in accordance with the changing external environment.

3.2.1 Inefficiency Crisis

This is the case when particular sectors of the company's business do not provide services in line with the average of competitors. Generally, it is the area of production which is most affected, due to obsolete equipment, incapacity or scarcity of manpower, or inadequate use of technology. The intensity of operational inefficiency may be determined both in terms of product costs and of inefficiency indices. Inefficiency, however, should not only be considered in operations, as it may also affect the administration sector where similar situations may be attributed to more or less serious shortcomings of the information system. Then we have to consider financial inefficiencies in obtaining credit on the market and in planning capital investments through financial instruments featuring an unlikely economic return (Guatri, 1986).