UNIT – 4

Corporate Restructuring

Objectives

The objectives of this unit are to

- commiserate the concept of corporate restructuring and reasons behind it.
- discuss the different types of corporate restructuring strategy
- high light the reasons of cancellation of paid up capital and corporate failures

Introduction: Changing economic environment within and across borders has led to change in the ways of conducting business. Due to competitive environment and enhanced standards of performance, companies have been experimenting with the policies, programs, products, processes and structure of the organization. Many firms have to adopt divestment strategies such as splitting the ownerships, cutting the jobs, selling off or shutting down the unprofitable segments. Further, the pace of change in global business environment is such that restructuring has become the buzzword in corporate circles. Survival and growth of business is not possible without profit. To maximize the profits, a firm can either adopt internal restructuring or external restructuring. Internal restructuring may include new products, change in manufacturing process and expansion of existing product lines. External restructuring may include mergers, demergers, amalgamations, absorptions, takeovers, consolidation and acquisitions. A firm has to continuously evaluate its capital portfolio, product mix, assets management and ownership to achieve to goals of wealth maximization and profit maximization.

4.1 Meaning: Corporate restructuring refers to the changes in ownership, assets mix, business mix and alliance with a view to achieve enhancement in shareholder value. It is a corporate management term referring to the act of reorganizing or partially dismantling a company for the purpose of enhancing efficiency and profitability. It may involve ownership restructuring (involve mergers and acquisitions, leveraged buyouts, buyback of shares, spin off, joint ventures and strategic alliance), business restructuring (diversification into new business, outsourcing, divestment, brand acquisitions etc.) and assets restructuring (sale and lease back of assets, securitization of debts, receivable factoring). In layman language, restructuring means replacing the older ways of doing business with the new ideas. It sometimes involves shutting down some segments of the company or severe staff reduction. Restructuring is often done as takeover by another firm or part of a bankruptcy particularly a leveraged buyout by a private equity firm. It includes a set of activities to bring about a significant change in its organizational structure and internal functioning that expand or contract a firm's operations or substantially modify its financial structure. Different forms of restructuring are mergers, takeovers, business alliances, buyouts, demergers, slump sales, equity carve outs, going private, leverage buyouts (LBOs) and performance improvement initiatives.

4.2 Motives behind Corporate Restructuring: The basic motive of corporate restructuring is to enhance the shareholder value/market value of share/value of the firm. Motives of restructuring are explained in the following paragraphs:

1. **Profit/Wealth Maximization:** Wealth maximization is the basic objective of financial management. Due to dynamic business environment firms may not be able to generate constant profits throughout their lives so they need change in business strategies. Higher earnings and the creation of corporate value are the basic goals of corporate restructuring. To create corporate value, a firm largely depends on its ability to generate adequate cash. Hence, corporate restructuring aims at maximizing firm's profits.
2. **Focus on Core Competence:** Core competencies are the combination of resources, processes and skills that distinguish a firm from its competitors and help its sustainability in the competitive environment. A business firm must identify, nurture, and develop its core competencies for lasting competitive advantage. Corporate structuring serves as a tool to leverage core competencies, the best way to increase the value of firm.
3. **Divestiture and Business Alliances:** Sometimes companies have to shut down those segments which are not competitive and incurring losses so that it can concentrate on its core activities. It can be achieved through strategic alliances or joint ventures etc.
4. Firms reorganize their capital structure to improve their financial health and increase the shareholders value.
5. A key factor for driving restructuring is reorganization of ownership within the promoter group, either due to family settlement, or exit of a joint venture partner.
6. One of the motives of restructuring is improved management. Firms generally suffer due to inefficient management. Hence they opt for change in higher level management.
7. Redesigning the business process for cost reduction and downsizing of workforce can be exercised through corporate restructuring.

4.3 Merger and Acquisition: Firms to survive and grow in present cut throat competition mergers and acquisitions is the only way out. Under merger, two companies lose their legal entities and create a new company or combine with each other under the legal entity of one of the current companies. They agree to integrate their operations on a relatively co-equal basis. The shareholders of the companies under merger decide to pool their resources under a common entity. Hence two or more companies combine into a single unit and lose their individual identities. Acquisitions are those mergers where one company obtains majority shares of another company by acquiring effective control over assets or management of another company. Thus in acquisition, two or more companies may remain independent, separate legal entity, but there may be change in control of companies. Mergers and acquisitions are the part of expansion strategy of an organization. It results in high growth and broadening the scope of business in terms of customers, functions, technology and overall performance. Many terms like merger,

amalgamation, takeover or consolidation are used interchangeably to explain corporate restructuring. Mergers per se, may either be horizontal mergers, vertical mergers or conglomerate mergers.

i) Horizontal Mergers: It is the merger of two or more companies operating the same product line or services within the same industry and at the same stage of production. Such companies are usually direct competitors. The main advantage of this merger is to eliminate competition, increase in market share, revenues and profits.

ii) Vertical Mergers: Under Vertical merger two or more firms combine which operate at different stages of production or distribution. For instance combing of a TV manufacturing company with TV marketing company. A vertical merger may take the form of forward or backward merger. The benefits of this type of merger are lower buying cost of materials, lower distribution cost, creating barriers to entry for new entrants etc.

iii) Conglomerate Merger: Under conglomerate merger two or more companies combine together which have been operating in completely different industries regardless of the stage of production. The main advantage of such mergers is diversification among the different industries hence, reduced risks.

iv) Concentric Mergers: Under **c**oncentric merger, firms under merger serve the same customers but with different products and services. Such companies usually offer the complementary products to the same customer base. For example, if a company that produces DVDs merges with a company that produces DVD players. These kinds of mergers offer opportunities for businesses to venture into other areas of the industry reduce risk and provide access to resources and markets unavailable previously.

Acquisition: The term acquisition is used in place of takeover. Acquisition is referred to describe the acquisition of ownership of rights in assets of another company. In the eyes of law after acquisition both acquirer and acquired companies maintain their separate existence. An acquisition is done keeping in mind the following:

i) Value Creating – Value creating means acquisition of a company by another company with the objective to improve its performance in terms of sales and profit.

ii) Consolidating – This is where a company acquires another company to eliminate competition.

iii) Accelerating – It refers to acquisition of a smaller company by larger company with the intention to use its greater resources to accelerate market access for the products of smaller company.

iv) Resource Resources – This kind of acquisition is done to acquire technologies, resources, intellectual property, skills or market position. Acquiring the resources is more cost effective than developing them.

4.4 Styles of Merger

There are many methods through which an acquiring company can initiate merger proceedings. Hence, the merger may also be classified on the basis of the **procedure** adopted or the style of the proceedings by the acquiring firm.

1. **Negotiated Merger:** It is also referred as friendly merger. For such merger, negotiation is executed for the merger plan by the manager, owners of the merging firms. The acquiring firm directly converse with the management of the target firm and gets first hand information about the expectations of the target firm. If both the firms agree the plan of merger, the proposal for merger is put before both the firms/companies for finalization.
2. **Tender Offer:** Tender offer involves bidding for the acquisition of controlling interest in the target firm by acquiring firm through purchase of shares of the target firm. The acquiring firm directly interacts with the shareholders of the target firm and requests them to sell their holdings at a fixed price. The proposed price is kept more than the current market rate so that the shareholders may attract to sell heir holding of shares.
   Under tender offer, there is no need to seek prior approval from the management of the target accompany by the acquiring company. The offer is kept open for fixed period of time.
3. **Hostile Take-over Bid:** The acquiring company tries to obtain controlling interest in the target company without the knowledge and approval of the management of the target company and purchases the shares of the target company in bulk through stock exchange. This type of action by acquiring company is named as 'raid'.
4. **Arrangement Mergers:** This type of merger is generally through the Board of Industrial and Financial Reconstruction under the revival package to merge sick companies with other stronger companies. These merger plans are executed target negotiations with the lead bank and both Target Company and acquiring company are also consulted. Such mergers are generally encouraged and the lead bank initiates the proceedings and sets the terms and conditions for the merger.

4.5 Benefits of Merger: The combination of two or more companies brings fruitful results such as increased profitability, cost reduction and optimum utilization of resources. Following are the benefits of merger:-

a) Synergy: Synergy means 2+2=5, the achievements of working together. Two firms with different complementary skills can create more value due to synergy effect, achieving the higher value than the sum of their individual value. Mergers or acquisitions mainly increase the effective value. For example, company A has various profitable investment opportunities, while Company B has huge financial resources. Hence combination of these two companies brings synergy effect by using huge financial resources to reap the profitable investment opportunities. Eventually increasing the profitability and enhancing the value. The merger is only beneficial if the combined value of the firm is greater than the individual values of the firms**.**

The value of AB Ltd.> the value of A Ltd. + the value of B Ltd.

b) Economies of Scale: It means reduction in unit cost a result of huge production. Production at large scale becomes possible if two or more companies combine. The economies of scale can be achieved due to optimum utilization of production capacities, research & development facilities, distribution networks, engineering services, etc. Horizontal mergers are the best examples to bring the economies of scale.

c) Economies of Scope: Under economies of scope, cost reduction is achieved by sharing the resources between the firms. Resources may be shared as manufacturing facilities, advertising campaigns, distribution channels and R&D cost etc.

d) Fast Growth: Merger enables fast growth as compared to internal expansion as the amalgamating firms can enter new markets instantly with the use of pre established plants and product lines. On the other hand, internal expansion takes quite long time to penetrate new markets, establish R&D, develop new product, and setting up a totally new administration.

e) Tax Benefits: Certain mergers help firms to utilize the tax benefits. Unabsorbed depreciation and accumulated losses of a loss making firm can be used to set off the taxable gains of the profit making firm with the help of merger.

f) Removal of Competition: Merger helps in removal of competition or sometimes formation of monopoly. When the competition between the rival firms becomes so intensive that forces the firms to price cutting and ultimately lower profits, merger is a good solution.

g) Diversification of Risk: Conglomerate merger is done to reduce the risk by diversification and thereby helps in stabilizing overall corporate income, which usually fluctuates due to change in economic, seasonal and product life cycle.

h) Managerial Effectiveness: Merger can benefit those companies which face managerial inadequacies. Such companies may combine with other companies with superior management to gain the congruence between the interests of management and the shareholders.

4.6 Valuation Methods in Mergers and Acquisitions Price and value are two different terms. Price refers to the amount paid to obtain goods /services or acquiring for running business, it doesn't necessarily reflect the value of that particular goods/service or acquired business all the time. Price may be higher or lower than the value of particular goods/services or business. There happens to be a significant difference between the value of a firm and the price paid for it. Hence, determination of the firm's value should be more important and realistic. The more accurate and realistic the valuation is, the more accurate can be the price to be paid for it. There are various methods of business valuation, which can be used according to suitability. For example, if a company has low return on investment, but posses high-value permanent assets in its balance sheet, then such assets considered more important than its rate of return in the valuation process. Following are the three majorly used methods for business valuation

a) Traditional Approach: Under this approach value of a business is determined by using the value of assets presented by the books of accounts i.e. Balance Sheet. Methods of traditional approach ignore the intangible assets such as technical know-how, patents, brand names, and management competence while valuing the business. Balance sheet-based methods mainly consist liquidation value, book value, adjusted book value, and replacement-cost value.

Book Value: It is calculated by deducting all the debts from the value of total assets presented in the balance sheet. Main reason for non suitability of this method in case of merger/ acquisition is, the uses book value instead of current market value. Another reason for non suitability is non inclusion of

intangible assets. This method can still be used in those organizations where the difference between the book values and the current market value is very small.

Adjusted Book Value: This method eliminates the drawbacks of book value method. The adjusted book value is calculated by using the current market values of the assets on the balance sheet date, and considering the values of the intangible assets as well.

Replacement-cost Value: Under this method, the value of the firm is calculated by using the replacement cost of the assets i.e. the costs of obtaining similar assets from the market. This method is also not very much suitable for mergers and acquisitions as it doesn't consider intangible assets.

Liquidation Value: The liquidation value is calculated by deducting the value of debts from the selling amount of assets in the market. It represents the lowest value that an organization can have. The liquidation value doesn't have any significance in mergers and acquisitions except in extraordinary situations. This method of valuation has significance in case of buying a business which has been making financial loss.

b) Income Statement and Market-Based Approach: Under this approach balance sheet data is not used, rather the value of the firm is determined by using income statement and market data.

Market Price: Under this approach market value of the firm is computed by using the market price of its shares. The market price of the shares depend on various inside and outside factors. Thus, the market price of the share may be higher or lower than its the real value. This method has various drawbacks such as it doesn't reflect the realistic value of the firm if the shares of the firm are not traded actively in the market. Political and Economic conditions can impact the market price of the shares highly resulting in higher or lower value for the company. The market prices are generally not consistent. They can change abnormally after the merger is announced.

Price/Earning Ratio: P/E ratio is the commonly used method in M&As particularly in the valuation of non-public companies, as it is easy to apply. The P/E ratio of similar company within the same sector listed in the stock exchange can be used for those non-public companies where the market price of shares cannot be ascertained. Here we use the reference of the P/E of another company. Under this approach, the current or future values of the firm are multiplied by the P/E ratio of the reference company. If there are no similar companies found, the P/E ratio of the sector can be used, as a more practical approach. Using the P/E of a similar company or the sector is not a suitable approach for M&As as it is based on the current or past values of the firms. However, it is accepted as an applicable and practical method where there is insufficient information about the firm with high uncertainty about the future.

c) **Discounted Free Cash Flows (DFCF) Approach:** Each company under merger should be valued separately to ascertain the synergy effect. Each company prepares Performa Income Statements to determine future free cash flows. The value of the firm is estimated by discounting the FCF with the weighted average cost of capital (WACC). It is relatively easy for companies to estimate their pre merger future free cash flows by using past data. However, it becomes more difficult to estimate future free cash flows for the combined firms after the M&A. Post merger FCFs can be calculated as follows:

FCF = EBIT (1-t) + Depreciation and Non-cash expenses− Capital expenditures for fixed assets. – Increase in net working capital

t= marginal tax rate

After calculating post merger FCFs, next step is to determine the discount rate by which free cash flows are discounted. Most commonly weighted average cost of capital (WACC) is used as discount rate. The costs of debt and equity to find the weighted average cost of capital are based on the desired capital structure post merger. After calculation of the post merger FCFs and the WACC, the discounted value of cash flows is determined. This value is happens to be higher than the total discounted values of the individual companies. If the above said value is lesser than the total values of individual companies, the merger doesn't create any effect in economic terms.

4.7 Leveraged Buy-Out: The term **Leveraged** refers to significant utilization of debt for financing the transaction and **Buyout** refers access of substantial control over equity of the target company. A leveraged buyout is the term used in case of acquisition where the acquirer company uses significant amount of borrowed money to meet the cost of acquisition. Here the assets of the targeted company are used as collateral for the loans along with the assets of the acquiring company. The outsider's money is used because of lack of cash to expand one's capability to make larger acquisitions. Typically LBOs require the setup of an acquisition vehicle which is jointly funded by a financial investor (outsider lender) and the management of the target company. The assets of the company to be acquired are usually taken as collateral for the debt. The target company goes private after a LBO. Generally, there is a debt-equity ratio of 90% and 10% in LBO. Due to this high debt ratio, normally, the bonds issued in buy-out are not kept in investment grade but they are called Junk Bonds. Hence, under LBO, an outsider financial investor (e.g. private equity fund) puts into a smaller value of equity (as compared to the total purchase price) and remaining consideration is paid by using leverage (debt or other non-equity sources of financing).

Let us understand the concept of a leveraged buyout with a simple example –

Suppose XYZ Corp. wants to buy ABC Corp without investing a lot of capital. The value of ABC Corp. is USD 2000.00. XYZ Corp. invests USD 200.00 of its own equity & remaining USD 1800.00 it borrows at an interest rate of 5% per year.

Particulars	**Figures**	**Figures**	**Figures**	**Figures**
Equity	$200	$200	$200	$200
Debt	$1,800	$1,800	$1,800	$1,800
Total Investment	$2,000	$2,000	$2,000	$2,000

Return Earned on Investment	10%	6%	5%	4%
Total Return	$200	$120	$100	$80
Interest(5% on $1,800)	$90	$90	$90	$90
Return on Equity	$110	$30	$10	($10)
Return on Equity (%)	55	15	5	(-5%)

In the first year of operations, XYZ Corp earns USD 200.00 (10%) from the cash flow of ABC Corp. Now the total value of ABC Corp. is USD 2200.00. XYZ Corp. repays its interest on debt i.e. USD 90.00 (5% of USD 1800.00). As you can see the company is paying interest of USD 90 to the financial institutions for its investment of USD 1800. Thus XYZ is left with USD 110.00 (USD 200.00 – 90.00) available for equity shareholders. XYZ Corp earns USD 110 on its original investment of USD 200.00. Thus, XYZ earned a 55% return on equity on this transaction. Now let's consider how much return XYZ Corp. would have earned had it financed the entire transaction by equity. To acquire ABC Corp, XYZ Corp. has to invest USD 2000.00. In the next one year, XYZ Corp. earned USD 200.00 from the cash flow of ABC Corp. Thus its total return = (200/2000) * 100 = 10%. Thus we can clearly see that the returns on leveraged buyout are much higher than a regular transaction. This example shows a very good return on equity because there is a positive effect of leverage here. This depends on the return on investment i.e. 10% here. If this return reduces to 4%, the return on equity will be negative. How? Amount left for equity shareholders is $80 (4% on 2000) less $90 (Interest) i.e. – $10 or -5%. If this return reduces to 5%, the return on equity will be minimal. How? Amount left for equity shareholders is $100 (5% on 2000) less $90 (Interest) i.e. $10 or 5%. If this return reduces to 6%, the return on equity will be average. How? Amount left for equity shareholders is $120 (6% on 2000) less $90 (Interest) i.e. $30 or 15%.

4.8 Buyout Process

1. Purchase Price and Amount of Debt and Equity

The first step in a leveraged buyout is to determine a purchase price for the target company. This is a valuation of the company based on various internal and external factors of the target company. Once the purchase price is fixed the buyer must decide what percentage of equity & what percentage of the debt will he use to carry out the acquisition.

2. Listing Sources of Finance & Types of Debts Available

We already know that two types of finances are used to fund a leveraged buyout – equity & debt. We also know the source of equity, but there are various types of debt available to the buyer. These sources include bank debt, bonds, commercial papers, etc. The acquiring company must decide on what type of debt it wants to exercise depending on interest rates, repayment terms, etc.

3. Build Projections

The acquiring company must build a future balance sheet & income statement projections for the target company. This will help to determine the rate of return from the investment. The buyer must have an approximation for revenue growth, income & expense percentage, net income margin, etc. The buyer can go one step further & compare their own projection calculations with that of equity researchers to account for any discrepancy.

4. Calculating Cash flow & Cash Available for Cash Repayment

Further after building projections it is necessary to calculate cash flows. There are various different cash flows such as free cash flow to equity, free cash flow to the firm, unlevered free cash flow, etc. Our motive to calculate cash flow is to calculate cash available for repayment. We will get that by the following formula –

Cash Available for Debt Repayment = Beginning Cash + FCF – Minimum Cash Balance

Where,

FCF (Free Cash Flow) = Cash Flow from Operations – Capital Expenditure & Minimum Balance

Minimum Balance = Least amount of cash that a company needs to continue operating, paying employees, and paying for standard expenses.

5. Analysis Payment Structure: Every type of debt comes with a repayment structure, which says how much debt is payable at what time. Some of this repayment is mandatory while some is optional. The acquiring company should be sure that it can adhere to at least all the mandatory repayments in a timely manner. The projections and estimates are very useful in analyzing this debt repayment structure as well.

6. Exit: As we already know that most of the time leverage buyout is a method of earning a good return on investment for a private equity firm. Thus it is necessary that the acquiring firm has an exit strategy in place. The acquiring firm at least has some assumptions about how & when it will exit. A typical exit assumption can be taken as the company being sold after 6 years at the same implied EBITDA multiple at which it was purchased. The basic understanding is that upon exit the acquiring firm will repay all the debt obligations of the target company as a part of the owner's obligation. But it also gets all the company's remaining cash at the end of the period as an owner.

7. Calculating IRR on initial Investment

The purpose of building a leveraged buyout model (LBO) is to calculate returns and determine if the LBO deal is attractive or not. The acquiring company looks at IRR to determine the attractiveness of an

LBO. Thus in the final step, the buyer derives an IRR from all the estimates of future projections and related research.

IRR= (Cash Flows)/ $(1+r)^i$

Where:

Cash flows= cash flows in the time period

r= Discount rate

i= Time period

4.8.1 Characteristics of a Good Leveraged Buyout (LBO): The prime motive behind a leveraged buyout is to use the cash of the target firm to pay back the debt applied for acquiring the target firm as soon as possible. A leveraged buyout (LBO) can have the following characteristics based on the main purpose:

1. Steady and Predictable Cash Flow – LBO ensures a steady and predictable cash flow to repay the interest for the debt taken. Steady and predictable cash flows make it easier to get a loan because there is a lesser risk of nonpayment of interest.

2. Enterprise Value/EBITDA Multiple - The Enterprise Value (EV)/EBITDA indicates the pattern as when and how easily the cash flows will be able to cover the purchase price. Enterprise Value refers to the total value of the firm i.e. long term debt plus market capitalization (equity).

3. Large Amount of Tangible Assets for Loan Collateral – Loan collateral consists of long term assets such as land and Building, plant & equipment etc. as well as short term assets such as cash inventory and other current assets. These tangible assets/loan collaterals make it easy to get a low-interest financing. Availability of easy and low-interest financing helps the acquiring firm easy repayment of the loans.

4. Potential for Expense Reduction – Management efficiency of the acquiring firm plays a greater role in reduction of expenses post LBO. Reduction in expenses enables to free up cash and helps in quick repayment of the debt. Private firms that are targets for LBO often have greater chance for reduction in expenses because of efficient management.

5. Minimal Future Capital Requirements – Under LBO, the acquirer doesn't need larger capital requirements in future to run the company. All it needs is to repay the debt.

6. Clean Balance Sheet with Little Debt - Less debt means less obligations to pay off. This makes the deal less risky and enables excess cash to utilize for leveraged buyout.

8. Strong Market position - A stalwart position in market ensures that the target company is not going to be destructed after the leveraged buyout. Such strong position makes cash flows less risky.

9. Divestible Assets - Divestible assets provide additional cushion to the acquirer to raise cash to pay off the debt more quickly particularly if the cash flows are endangered.

10. Viable Exit Strategy - The theme of leverage buyout aims getting good return on the equity investment by selling the company after a few years of the LBO. In the absent of viable exit plan LBO is probably not going to work.

4.8.2 Management Buy-Out: An MBO is a type of a leveraged buyout. It is a transaction in which a combination of equity and debt is used to purchase a company by the management. Further, the target Company's cash flow is collateral to secure and repay the debt. Since management hardly has the funds to buy the target company, hence they need to take debt to finance the buyout. In simple words, a management buyout (MBO) is a transaction where the management pools resources to acquire completely or partly, business managed by them. MBOs can be performed with any size business in any industry. It can be used for monetizing the owner's stake in a business or divesting a particular department from the core business. In some cases an MBO takes over a company from publicly-traded to private one.

Motives behind MBO: Following can be the reasons or motives on the part of buyer and seller behind MBO:-

1. It provides peace of mind to the owner/seller who wants to retire or cash out their position passing the company to known or trusted group.

2. MBO provides strategic advantages to the owner in terms of reducing the risk of disclosure of his confidential information, because the deal is done between the management and the owner without involvement of any third party.

3. MBOs can be a fascinating tool to go private by public Ltd. companies/corporations by executing a long-term turnaround strategy (selling or divesting a non core segment which is also unattractive for the shareholders).

4. Management pursuing MBO can earn direct financial rewards for their hard work and efforts by growing the value of the business. They feel more confident about using their experience and expertise to grow the business they bought by improving its operations. Therefore, by investing in the company they ultimately invest in themselves.

5. MBO is a quickest, easiest and less risky way of taking over the ownership of the company by its management. In an MBO, the buyers already have an inside look and in depth knowledge of the asset and other resources of the business which reduces the risk inherent in the investment.

6. Other Stakeholders such as customers, lenders, suppliers and the employees also get benefitted from an MBO. Because they don't have to deal with the new people, existing management stays in place which makes it comfortable for the other stakeholders to operate with the company.

Steps in MBO Execution: Process of MBO is not a short term procedure. First of all, the management needs to gain the trust and build the credibility with the existing owners of the company. It can be achieved over time by putting lots of efforts in improving the business and communicating the results to the owners in a transparent, straightforward and consistent manner. The next step is to assess the

opportunity and plotting a proper plan to purchase the asset. Opportunity can be identified by analyzing a number of events such as:-

1. Retirement of the existing owner with no successors of the business.

2. Desire of the management team to become the owners of the business.

3. Business is underperforming. But the current strategy employed by the owners is different from the management.

Below are given sequential steps of MBO process commencing from Employees and terminating on Owners for easy understanding:

Employees → Establish credibility with owners → **Opportunity to purchase the business you work** → Assess the opportunity and risk → **Assess the commitment required** → Write a business plan → **Negotiate the terms of sale** → Raise finance → **Complete due diligence** → Close deal → **Owners**

4.9 Financial Reconstruction

In the cases of merger, take-over and integration, etc., of corporate restructuring, the potential receiver firm has to deal with the management or shareholders of other firm/firms. On the other hand, the function of financial reorganization is an internal function executed with the consent of all the stakeholders. This is the simpler and easier form of corporate reorganization to be followed.

Meaning of Financial Reconstruction: Financial restructuring includes rearrangement of financial structure of the company in order to make its finances more balanced. A company shouldn't be either undercapitalized or overcapitalized. Financial restructuring can be done by various methods such as reduction in Capital, buyback of shares, reorganization/ consolidation of capital, subdivision, further issue of shares etc. Financial restructuring becomes compulsory on the occurrence of any of the following situations:

(i) Requirement of huge working capital to reach desired level of production or services so that the market demand can be fulfilled.
(ii) Inability of the company to meet its current commitments.
(iii) When the company is not given further credit by the suppliers (e.g. consumables, raw materials, bought-out components etc.) and the job workers etc.
(iv) Inability of the company to operate on optimum production capacity due to lack of liquid funds.

4.9.1 Objectives of Financial Reconstruction: To free the company from acute financial crisis and to enhance its efficiency, the financial reconstruction is urgently required. To control situations like over-capitalization, increase in the burden of fixed liabilities, lack of additional capital, fall in the earning capacity, default in capital cover, etc., the last resort is financial reorganization. Otherwise the company may have to close its business. The following are the main objectives of reorganization:

1. To avoid the damaging situation of over-capitalization and keep the company safe and secured under adverse and non-favorable conditions

2. To arrange for additional capital, by incorporating certain changes in the capital structure of the company,
3. To reduce the fixed expenses by converting debentures into equity shares
4. By writhing off the losses of past years and increase the earning capacity and its creditability and goodwill
5. To make cash position of the company sound to pay its liabilities and to distribute dividends.

Schemes of Financial Restructuring: Corporate financial restructuring refers to substantial changes in the financial structure, business portfolio, Control/ownership etc of the company. It is done to increase the value of the firm, i.e., equity or debt restructuring. Simplest form of financial restructuring is internal reconstruction, under which, the liabilities of the company are reduced by negotiation with various stakeholders such as creditor, banks, debenture holders, financial institutions, and shareholders etc. It deals with raising the funds for new projects by restructuring the capital base.

1) **Debt Restructuring:** It mainly involves extension in payment terms, variation in conditions and reduction in debt to make it less expensive. It is a negotiation procedure done mainly with vendors, creditors and bankers. It means reorganizing the whole debt capital of the company. It impacts the balance sheet of the company by reshuffling the items of debt obligation. Debt capital includes short term borrowings and secured/unsecured long term borrowings.

• It helps improving the liquidity position of a sick company and increases its cash flows by restructuring its long-term secured borrowing. On the other hand, it reduces the cost of capital for a healthy company.

• Long-term unsecured borrowings can be restructured in form of private loans, public deposits and privately placed unsecured debentures or bonds.

• Short term borrowings such as inter-corporate deposits clean bills & clean overdraft etc are generally not considered for restructuring rather, these can be renegotiated with new terms.

• Debt-equity swap is the best method of corporate debt restructuring. In this method, specified shareholders are given right to exchange their stock with debt such as bonds on a predetermined value within the company.

2) Equity Restructuring: It refers to reorganization of the equity capital. Shareholders capital and the reserves appearing in the balance sheet are reshuffled with the view of increasing overall market value of the firm’s common stock. It involves changing the distribution pattern of firm’s residual cash flows among the shareholders. Restructuring preference and equity capital is a complex process as it involves various legal compliances. Forms of equity restructuring:

• Alteration of share capital

• Reduction of share capital

• Buy-back of shares

a) Alteration of Share Capital. According to section 61 of the Companies Act, 2013 "A limited company having a share capital derives its power to alter its share capital through its articles of association. As per the section the company may alter its memorandum in its general meeting to: increase its authorised share capital by such amount as it thinks expedient, consolidate and divide all or any of its share capital into shares of a larger amount than its existing shares, convert all or any of its fully paid-up shares into stock, and reconvert that stock into fully paid-up shares of any denomination, sub-divide its shares, or any of them, into shares of smaller amount than is fixed by the memorandum, cancel shares which, at the date of the passing of the resolution in that behalf, have not been taken or agreed to be taken by any person, and diminish the amount of its share capital by the amount of the shares so cancelled. The cancellation of shares shall not be deemed to be a reduction of share capital. If a company increases its capital beyond the amount of authorised capital, it shall increase its authorised capital by the amount of new shares"

ii) Reduction/Cancellation of paid up of Share Capital: Reduction of share capital means reduction of issued, subscribed and paid up share capital both equity and preference of a company. Capital reduction commonly takes place with pay out or without payout or selective for a certain class of shares with or without payout subject to the fulfillment of conditions prescribed by laws

Examples: i) The shares of face value of Rs 125 each of which Rs 100 paid, the company may reduce them to Rs 100 fully paid-up shares and thus relieve the shareholders from liability on the uncalled capital of Rs 25 per share.

ii) The shares of face value of Rs 100 each fully paid-up is represented by Rs. 75 worth of assets. In such a case, reduction of share capital may be effected by cancelling Rs. 25 per share and writing off similar amount of shares.

iii) The shares of face value of Rs 100 each fully paid-up reduced to face value of Rs. 75 each by paying back Rs. 25 per share

Objectives of Capital Reduction/Cancellation

1. To remove bloat of balance sheet arised from accumulated losses funded through share capital/share premium. Setting of accumulated losses against share capital/reserves leads to right size of balance sheet.

2. To refund the surplus funds to the shareholders either by reducing the face value or by cancelling some shares.

c) Buy Back: "According to Section 68(1) of the Companies Act, 2013, a company whether public or private, may purchase its own shares or other specified securities (hereinafter referred to as "buy-back") out of: (i) its free reserves; or (ii) the securities premium account; or (iii) the proceeds of any shares or other specified securities"

Share Split : A stock split is restructuring the share capital of a company by increasing or decreasing total number of outstanding shares without changing proportionate ownership of existing shareholders and total amount of share capital. There is no change in the balance sheet of company except the total

number of outstanding shares. For example when the company announces that it will go for a 2-for-1 split of its equity stock. It has 2,000 outstanding equity shares of Rs. 50 per share before a 2:1 split. After stock split it will have 4,000 outstanding equity shares Rs. 25 per share. Although the number of outstanding shares changed from 2000 to 4000 and stock prices changed from Rs. 50 to Rs.25, the market capitalization remained constant Rs 100,000.

Need for Stock Splits. A share split is usually carried out when the price of share have reached at such a high level or above the price levels of similar corporations in same industry. The basic purpose of share split is to make shares affordable to small investors without changing the underlying value of the company. There are several reasons companies consider while carrying out this corporate action: -

a) **Affordability and Liquidity** – When the share price is such a high level that it cannot be popularly traded among normal investors except HNI or institutional investors and because of this the trading volume decrease and investors move away. The management declares a stock split to make it affordable and liquid.

b) **Psychological Effect –** As explained in para a) Splitting of the stock is done to brings the share price down at attractive trading level without change in the total underlying value that is purely psychological effect to lure new investors

c) **Performance Indicator -** Companies generally adopt the action to split their shares as symbol that its stock has attained a certain desired level of success and is a faster growing firm.

d) **Broadening of Shareholder Base -** Stock split is done to broaden shareholder base and make a wider number of people to own the shares.

4.10 Corporate Failure - The term corporate failure means discontinuation of company's operations leading to inability to reap sufficient profit or revenue to pay the business expenses whatsoever reasons. Corporate failure may happen due to poor management, incompetence, and bad marketing strategies etc. In a global competitive business world, corporate failure occurs because of non adaptability of changes. The financial trends reflect the symptoms of corporate failures which are inter-related to on another. First of all a company faces a downfall in its earnings, which is reflected in the profitability ratios, such as profit margin, return on capital employed, return on investment etc. The ill effects of corporate failure are unemployment, increasing the level of poverty, depriving creditors of their legitimate earnings intensifying the crime rate and reduction in the volume of tax earnings for government. In simple language corporate failure destabilize the economic system.

Causes of Failure of Corporate Enterprises: Corporate failure could be caused by number of factors, such as:

1 **Inefficient and Ineffective Board:** The root cause of corporate failures is the lack of efficient and efficient board of directors team. Lack of skills, experience in core area of business riddled with conflict of interest, repeated fiduciary failure, absence of corporate strategic planning etc on the part of top management led to many corporate failure within country and outside.

2. Societal Factors: Products and services offered by firm may be rejected over a period of time by its customers whatsoever reasons. Simply when a firm has tough times selling its products in domestic market will look for distant markets which will lead to higher marketing costs and inability to sell its products.

3. **Economic Turbulent:** Economic instability or down turn in the economy caused financial distress to many firms in the past globally resulted corporate failure.

4. **State Policy:** Many a time government policies act against the operations of business. In such situations firms have no other way to avoid bankruptcy.

Effects of Corporate Failure 1) Unemployment level are increased. 2) Living standard falls 3) Resources are not employed 4) Criminal and unethical activities are increased 5) Level of Non-performing assets mounted in the balance sheets of bank 6) Instability in financial markets.

4.11 Liquidation: "As per Section 2(94A) of the Companies Act, 2013, winding up means winding up under this Act or liquidation under the Insolvency and Bankruptcy Code, 2016. Winding up is a means by which the dissolution of a company is brought about and its assets are realised and applied in the payment of its debts. After satisfaction of the debts, the remaining balance, if any, is paid back to the members in proportion to the contribution made by them to the capital of the company." "The liquidation or winding up of a company is the process whereby its life is ended and its property is administered for the benefit of its creditors and members. An Administrator, called a liquidator, is appointed and he takes control of the company, collects its assets, pays its debts and finally distributes any surplus among the members in accordance with their rights." Winding up ultimately leads to the dissolution of the company. During winding up process_ the legal entity of the company remains and it can sue and be sued in a court of law.

Modes of Winding Up of a Company: A company may be wound up in any of the following two ways**:**

1. Compulsory Winding Up of a Company: "Winding up a company by an order of the Tribunal is known as compulsory winding up. Section 271 of Companies Act, 2013 provides for circumstances in which a company may be wound up by Tribunal.

a) When the company has, by special resolution, resolved that the company be wound up by the Tribunal;
b) If the company has acted against the interests of the sovereignty and integrity of India, the security of the State, friendly relations with foreign States, public order, decency or morality;
c) When on an application made by the Registrar or any other person authorised by the Central Government by notification under this Act, the Tribunal is of the opinion that the affairs of the company have been conducted in a fraudulent manner or the company was formed for fraudulent and unlawful purpose.
d) If the company has made a default in filing with the Registrar its financial statements or annual returns for immediately preceding five consecutive financial years; or
e) When Tribunal is of the opinion that it is just and equitable that the company should be wound up."

Petition for Winding Up: "A petition for compulsory winding up of a company may be filed in the Tribunal by any of the following persons.

i. Petition by the Company - A company can file a petition to the Tribunal for its winding up when the members of the company have resolved by passing a Special Resolution to wind up the affairs of the company. Managing Director or the directors cannot file such a petition on their own account unless they do it on behalf of the company and with the proper authority of the members in the General Meeting.

ii. Petition by the Contributories - A contributory shall be entitled to present a petition for the winding up of the company, notwithstanding that he may be the holder of fully paid-up shares or that the company may have no assets at all, or may have no surplus assets left for distribution among the holders after the satisfaction of its liabilities. It is no more required of a contributory making petition to have tangible interest in the assets of the company

iii. Petition by the Registrar - Registrar may with the previous sanction of the Central Government make petition to the Tribunal for the winding up the company only in the following cases:

(a) If the company has made a default in filing with the Registrar its financial statements or annual returns for immediately preceding five consecutive financial years;

(b) If the company has acted against the interests of the sovereignty and integrity of India the security of the State friendly relations with foreign States, public order, decency or morality;

(c) If on an application made by the Registrar or any other person authorised by the Central Government by notification under this Act, the Tribunal is of the opinion that the affairs of the company have been conducted in a fraudulent manner or the company was formed for fraudulent and unlawful purpose or the persons concerned in the formation or management of its affairs have been guilty of fraud, misfeasance or misconduct in connection therewith and that it is proper that the company be wound up.

iv. Petition by the Central Government or a State Government on the ground that company has acted against the interests of the sovereignty and integrity of India, the security of the State, friendly relations with foreign States, public order, decency or morality.

v. Any person authorised by the Central Government in that behalf."

2. Liquidation under Insolvency and Bankruptcy Code 2016: "The Insolvency and Bankruptcy Code, 2016 relates to re-organisation and insolvency resolution of companies, partnership firms and individuals in a time bound manner. The Insolvency and Bankruptcy Code, 2016 applies to matters relating to the insolvency and liquidation of a company where the minimum amount of the default is Rs. 1 lakh (may be increased up to Rs.1 Crore by the Government, by notification). The Code lays down following two stages:

1) Insolvency Resolution Process -

It is the stage during which financial creditors assess whether the debtor's business is viable to continue and the options for its re-organisation and re-structuring are suggested;

2) Liquidation: and in case the insolvency resolution process fails, the liquidation process shall commence in which the assets of the company are realized to pay off the creditors."

Modes of Dissolution: Dissolution of a company may be brought about in any of the following ways:

1. Through transfer of a company's undertaking to another under a scheme of reconstruction or amalgamation. In such a case, the transfer or company will be dissolved by an order of the Tribunal without being wound up.

2. Through the winding up of the company, wherein assets of the company are realized and applied towards the payment of its liabilities. The surplus, if any is distributed to the members of the company, in accordance with their rights.

Self Assessment Questions

1. Explain the term corporate restructuring. Highlight the different types of corporate restructuring plans.
2. What is financial reconstruction? Discuss the objectives of financial reconstruction.
3. Who can file the petition for winding up of accompany?
4. Discuss the motives behind MBO and its execution procedure.
5. Write notes on:- LBO, vertical and horizontal merger, Share split, Insolvency and Bankruptcy code 2016.
6. Explain the features of good LBO.

Suggested Book Readings:

1. Financial Management:- By M Y Khan and P K Jain, Tata McGraw Hill Education Private Limited.
2. Financial Management:- By I M Pandy, Vikas Publishing House PVT. LTD.
3. Financial Management:- By G Sudarsana Reddy, Himalya Publishing House.
4. Financial Management:- By Shashi K Gupta and R K Sharma, Kalyani Publishers