Reflections on Financial Restructurings in Emerging Markets

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Abstract

On the basis of dissertation work surveying several cases in Venezuela, attention is given to corporate financial restructurings. A number of preliminary thoughts are explored on the inception and management of corporate financial crises in this highly volatile political and economic environment, and a tentative list of key success factors for restructurings in emerging markets is proposed. The paper closes with some suggestions for further empirical research.

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Introduction

This paper serves as a first approximation to the underlying processes behind corporate financial restructurings in emerging markets, and is based on dissertation work surveying a number of cases in Venezuela.[1]

The paper starts with a brief review of the basic theoretical background on capital structure and financial distress with a focus on developing countries. Following this, a number of preliminary thoughts are explored on the inception and management of corporate financial crises. These ideas are contrasted with the realities of the business environment prevailing in emerging markets to produce a tentative list of key success factors for restructurings in these nations. Some suggestions for further empirical research are offered at the end.

The reader should be aware that, being based on a particular country, these conclusions are preliminary. It is only hoped that future empirical studies will clarify and enrich these ideas so that they can evolve into more general propositions for emerging markets.

Theoretical Background

The theory of capital structure (Miller & Modigliani 1958, 1963) established the theoretical foundations of the optimal level of debt. When leverage increases, on the one hand, the tax shield reduces the cost of capital and, on the other hand, the costs of financial distress increase. Therefore, there must exist a level where the cost of capital is minimized and leverage is optimal.

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[1] I am indebted to my students M. H. Acevedo, C. Delgado, M. E. Iraguen and M. A. La Rocca, who in the course of their dissertations id the field work that laid the basis for this paper. I also wish to thank Alejandro Reyes, Carlos Jaramillo and Phillippe Erard for their constructive remarks.

Optimal leverage corresponds to the point at which the marginal cost of financial distress matches the marginal benefit of the tax shield. This point depends on the actual shape of these two functions (Barnea, Haugen & Senbet 1980).

Unfortunately, the costs of financial distress are very difficult to estimate, and consequently the computation of optimal leverage in this manner is out of reach for all practical purposes. Therefore, these ideas serve more as a conceptual reference than as an applicable real life procedure.[2]

The following formula expresses this conclusion quantitatively:

$$V = V_u + DT_C - PV\left(CFD\right)$$

where:

V_u is the value of the unleveraged firm
D is the amount of debt
T_c is the corporate income tax rate
PV(CFD) is the present value of the costs of financial distress (CFD)
DT_C is the present value of the tax shield corresponding to taxes saved due to interest expenses.

This formula is based on the following assumptions: a) no transaction costs; b) perfectly competitive financial markets; c) no agency costs; d) no personal or other taxes other than corporate income taxes and e) all cash flows being non-growing perpetuities.

Not only are the costs of financial distress difficult to quantify but also the Miller-Modigliani assumptions are unrealistic, especially in emerging markets. Hence, the theory of capital structure is a good

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[2] Opler, Saron & Titman 1997 propose a method to estimate the costs of financial distress.

starting point but its lack of realism makes it unfit for the practical determination of leverage.

This conclusion is valid everywhere, but even more so in the developing world, where other determinants can weigh heavily on the optimal capital structure.

The Case of Emerging Countries

Since the publication of the seminal papers by Miller and Modigliani (1958, 1963) considerable research has been done towards gaining a better understanding of corporate capital structure. Nevertheless, although extremely valuable, this research pays attention almost exclusively to the developed world.

Hence, emerging markets being the focus of this paper, this important work will not be discussed here. Only two important factors influencing leverage in these countries are worth mentioning in the present context: the economic and institutional climate, and capital rationing considerations (Sabal 2002).

Economic and institutional climate

The economic climate in emerging countries tends to be uncertain. External shocks and government intervention create high and unpredictable volatility. There are periods of relative stability followed by others in which uncertainty is so intense that any forecast longer than a few weeks is quite unreliable. Leverage is tied to volatility. If volatility is difficult to predict so will be the debt ratio. Therefore, emerging market firms should be much more cautious about taking on debt than their counterparts in developed countries.

Another noteworthy aspect is the frequent disequilibria between inflation and interest rates. Sometimes interest rates fall so far that they become negative in real terms. At other times they rise to very high levels. In consequence it might not be advisable to keep a stable debt ratio. Instead, firms must be prepared to adjust leverage up or down rapidly depending on the level of interest rates. It is for this reason that an important success factor in some emerging markets is the availability of alternative funding sources (debt or equity) that can be tapped rapidly at any time.

Something similar occurs with debts in hard currency since exchange rates are also likely to be out of balance with inflation and interest rates. As a result, this type of debt can be a good idea at times but not at others. Again, a high dosage of manageability is required to be able to adjust the debt profile quickly.

In principle, only export companies with reliable sources of foreign exchange can be advised to maintain long-term commitments in hard currency. Nevertheless, when there is no significant convertibility risk and local currency income has a stable and strong correlation with the exchange rate, long-term commitments in hard currency can be justified as well.

Bankruptcy constitutes another important issue. In many emerging countries, bankruptcy laws and procedures can be so cumbersome and unfair that some stakeholders end up bearing a disproportionate share of bankruptcy costs. Also, it is not rare for liquidation to turn out to be the only way out of a financial crisis.

Capital rationing

The majority of emerging market companies face significant barriers to access funds rapidly and at reasonable costs; in other words, their sources of capital are rationed. The interaction of capital rationing with other market particularities gives rise to important implications as regards firm leveraging. In particular the role of cartels should be noted.

Cartels proliferate in emerging countries. One common tactic of these firms is to gain market share by ousting a competitor, even if it means taking losses in the short run. Competitors with weaker financial positions will be the first to suffer the consequences of such tactics. Therefore, when there is capital rationing, in oligopolistic markets, the debt ratio of each firm should be a function of the debt ratio of the other firms in the same market.[3]

Hence as a general conclusion, *ceteris paribus*, it is advisable for firms in emerging markets to have lower leverage than their counterparts in the developed world.

Financial Distress

The causes of financial distress are varied. The most common are uncompetitive products and services, poor productivity, ineffective management and unwise investment decisions. However, in the case of emerging markets financial distress can easily be caused by external factors such as erroneous macroeconomic policies or external shocks.

There are four generic terms associated with financial distress in the literature (Altman 1993): failure, insolvency, default and bankruptcy.

Failure occurs when the realized rate of return on invested capital adjusted for risk is significantly and continually lower than prevailing rates on comparable investments. Insolvency takes place when a firm cannot meet its current obligations due to a lack of liquidity. A firm is in default when a covenant with a creditor is violated, which lays it

[3] Antitrust authorities tend not to be very effective at stopping this kind of behavior in most emerging countries.

open to legal action; and bankruptcy arises when the net worth position of the enterprise is negative, that is, when total asset value is less than total liabilities.

Often financial distress ultimately leads to a reorganization or restructuring process. Paraphrasing Altman:

"A corporate restructuring is any substantial change in a firm's asset portfolio or capital structure. Its objectives are usually to increase value to the owners, both old and new, by improving operating efficiency, exploiting debt capacity, and/or redeploying assets."

Reorganization is advised whenever an entity's intrinsic or economic value is greater than its current liquidation value. When the opposite is true, liquidation is the preferable alternative.

Financial Restructurings in Emerging Markets

Below, the main issues regarding the observed processes of financial distress that led to financial restructurings will be discussed. The purpose is to reach a set of tentative conclusions on financial reorganizations in emerging markets. Further on, a number of key success factors for corporate restructurings in emerging markets will be proposed and some questions for future research on this matter will be raised.

It must be borne in mind that, being based on just a few cases that took place in a particular country, these conjectures are preliminary.

Inception of financial distress

The causes of financial distress in emerging countries are not dissimilar to those found in advanced economies: uncompetitiveness;

low operational efficiency; bad management; bad investment decisions, etc. However, as stated above, for a given level of debt financial distress is more likely for firms in developing countries.

Not only does the volatility in the economic and political atmosphere add uncertainty to financial obligations but, as mentioned earlier, the oligopolistic environment that is prevalent in most industries exposes weaker firms to the threat of aggressive actions by stronger competitors seeking the opportunity to gain market share. For firms under financial strain the end result is often a reduction in operating margins sparking a vicious cycle towards financial collapse.

It is common for management to wait excessively before recognizing the imminence of a financial crisis. Furthermore, the crisis is not generally acknowledged until payments to suppliers and creditors are in arrears due to a lack of liquidity. Much the same happens among financial claimants, who are likely to disregard the warning signals emanating from their risk control desks. It is as if for some reason both managers and financial creditors want to postpone the admission of the crisis, hoping that somehow things will improve along the way.

It is an open question whether this wait-and-see attitude is more pronounced in developing countries, but in any case it might stem from two possible causes. On the one hand, most companies are not public and therefore are not subjected to pressures from low market valuations of their stock. On the other hand, there might be a frame of mind that is adapted to ever-present volatility. After all, some unexpected government decree or a sudden change in the foreign exchange or interest rates could suddenly improve the position of the firm, thus reversing the situation at a stroke.

Unfortunately, when external causes do not help the company out of its problems and the financial emergency becomes unavoidable it is often found that unprofitable business units were kept for too long and costs were not reduced fast enough, turning a bad situation into a disaster.

Once the crisis is inescapable the most important question to answer is whether its causes are structural or circumstantial. As was mentioned above, in the first instance, it might be that the business is simply not be viable and the best solution is liquidation. Only in the second case might a restructuring plan make sense.

Two ways to handle the financial crisis

Be it liquidation or restructuring, two formal ways exist to handle a financial crisis: private negotiations or a judicial procedure similar to Chapter 11 in the United States of America.

A key step in all judiciary procedures is for the authorities to name an official with ample powers to settle all claims. This official is usually a lawyer or some other professional with no knowledge of business whose only goal is to liquidate and distribute whatever is left among the claimants.

In the field work on which this paper rests it was found that these officials usually obstruct negotiations and tend to act in an authoritative manner. Thus, it is not surprising that the judiciary approach generally results in a huge destruction of value and small recovered amounts for all claimants. In addition, owing to the fear that some measure of corruption may get in the way, the whole process is on occasions tarnished by a lack of trust from all parties involved.

Consequently, judiciary procedures are rarely desirable and should only take place when no agreement whatsoever is feasible among the claimants.

From here on it will be assumed that the judiciary process is discarded (as it appears it should be in many emerging market situations) and the focus will be on private restructurings.

Management of the financial crisis

Once a situation of unsustainable financial distress is recognized management must put in place a financial restructuring plan encompassing a short-term and a medium-term program.

The short-term program seeks to obtain the liquidity necessary to comply with the most pressing obligations and preserve the company's operations in acceptable shape. This stage usually involves selling non-essential assets and obtaining bridge loans.

The short-term program is crucial for buying the time to implement a successful medium-term restructuring. However, it also alerts creditors of the impending crisis, thus triggering actions to protect their claims. This has an immediate impact on the company's operations and in turn precipitates the longer-term restructuring process.

Financial theory teaches us that, for the firm as a whole, present value maximization is to the benefit of all. Thus, in principle it should be the main purpose of any restructuring process. Unfortunately, in most restructurings each party is inclined to pose the situation in a perspective favorable to them and to take every possible action to gain bargaining power. Managers and shareholders take advantage of their superior information. Suppliers restrict credits and shipments. Financial creditors threaten with legal action or other disruptive measures to make good their claims.

This divergence of interests complicates the negotiating process in such a way that destruction of value is always unavoidable and present value maximization becomes an impossible goal for all practical purposes. Even worse, the final outcome is rarely fair for all parties involved. In consequence, a general principle of every financial restructuring is that everybody loses and that participants must be prepared for a painful negotiating process in which each one seeks to lose as little as possible.

This is why strong leadership and competent management respected by all are probably the most important success factors in a corporate restructuring. The overall aim must be to generate trust and as far as possible align all the parties involved towards a suboptimal but credible and acceptable restructuring plan (more on this below).

Regrettably, strong and competent guidance is hardly ever attainable due to the presence of a multiplicity of claimants with the most varied and interlinked interests.

Claimants

The main claimants can be grouped as: employees, the tax authorities, suppliers, financial creditors and shareholders.

In general, employees possess the highest priority, followed by the tax authorities. Unless they hold some kind of guarantee, financial creditors and suppliers come together in third place. And of course, shareholders are last.

Frequently employees somehow manage to wield considerable political pressure, either because they are unionized or for some other reason. Hence, this group tends to be a successful claim collector.

In many instances the government is in a fragile bargaining position. Public offices in developing countries are usually disorganized. Most of their staff is underpaid, incompetent, unmotivated and overwhelmed by work. Files are wrongly classified and hard to find, and the few controls in place are usually ineffective. Therefore, when the time comes to advocate its claims it is generally too late and the government turns out to be a weak negotiator.

As mentioned above, financial and non-financial creditors (mainly suppliers) fall into more or less the same priority category. However, in most cases non-financial claimants adopt a short-term perspective, are unwilling to collaborate with the firm's survival and tend to be aggressive, especially when their claims are relatively small. Moreover, their supplies might be critical to sustain operations. Thus, they often yield considerable bargaining power and for all practical purposes come second in line after employees.

Financial institutions are last before stockholders. They constitute the core creditors and are supposed to be sophisticated enough to participate in the negotiations with a longer-term outlook. However, being a heterogeneous group, this laudable longer-term attitude materializes in different manners for each claimant.

Financial Claimants

Financial claimants comprise banks and bondholders. Banks usually bear the bulk of the debt and tend to conduct the negotiations whereas bondholders are generally represented through an intermediary, usually a bank.

The banks' exposure to the credits in arrears is a key determinant of their negotiating stance. As is to be expected, the greater the relative importance of these credits, the more they have at stake and the more senior the executives assigned to the negotiating team will be.

While it is true that banks have a longer-term perspective this does not go as far as to make them think in terms of present value maximization. The reason for this apparently "irrational" behavior seems to lie in an agency problem.

As soon as a creditor defaults the bank is obliged to make a loss reserve in its books equal to the full amount due. Part of this reserve is reversed, with a favorable impact on bank profits, once a payment agreement is reached. Current profits weigh much more in the compensation of bank managers than uncertain results years into the future. Therefore, managers responsible for restructuring negotiations are biased towards improving bank profits (and hence their compensation) as quickly as possible and tend not to be much concerned about the prospects of the company in trouble. As a result, financial creditors tend to value fixed assets much more than potential future profits, an attitude that frequently results in considerable destruction of value (Gilson 1990).

In short, there is a kind of "accounting bias" that portrays present value maximization as a minor consideration in comparison with current accounting profits.

In the later stages on their way to financial distress companies face difficulties securing new funding from their traditional sources. Therefore, it is not unusual for these firms to initiate business with different banks interested in beginning a relationship with a new client. In the end, once the crisis is manifest, these new creditors find themselves with large defaulted debts that often have a disproportionate weight in their balance sheets. These banks generally turn aggressive in the restructuring process, much alike commercial creditors, adding complexity to the negotiating process.

Guarantees

Not all banks have the same negotiating power. Those who hold some kind of guarantee are in a stronger position. But the type of guarantee can make a big difference.

There might be guarantees that have little or no effect on the company's performance, such as shareholders' personal property, financial assets or real estate not essential for operations. However, others like machinery or inventories will have a significant impact on the firm's functioning. In the first case, the creditor tends to be in a comfortable position and it is easy for him to reach a separate agreement with the debtor.

But things get more complicated when the guarantees are tied to the company's operations. In this instance, their marketability defines the creditor's negotiating power. If the guarantees can be easily liquidated with little loss, the creditor is likely to accept them as payment regardless of the effect on the firm and other creditors' claims.

On the other hand, when the guarantees are illiquid the creditor is not inclined to accept them in payment but still holds a strong bargaining chip: if he does not end up with an agreement to his satisfaction he can take possession of the guarantee, affecting the company's future and thus the value of his peers' claims.

Thus, it can be seen how the presence of asymmetries among creditors as to the existence and types of guarantees can have a major effect on the firm's future and hence on the value of all claims.

Other considerations

The general economic situation in the country can be critical regarding the banks' attitude towards financial restructurings. Banks tend to be more flexible in difficult economic conditions when numerous bankruptcies occur and there are more credits in peril.

Interrelationships among banks can play a role as well. Collaboration among them depends on what else there is on their agendas that is related to other banks involved in a particular restructuring. For instance, when the same banks are involved in a number of different workouts there are more options to balance weaker positions in one case against stronger positions in another, and cooperation is likely to arise more easily.

Given the smaller and more closed business environments prevailing in emerging markets, these types of interrelations are likely to play a much more important role in these nations.

Business policy is another factor. Banks can be more conservative or more aggressive, or have a longer or shorter-term perspective. Also, banks can be product oriented or relationship oriented. Product oriented banks place greater importance on product profitability (i.e. corporate credits) and tend to be rigid restructurers whereas relationship banks look for a long-term relationship with the client and are liable to be more flexible.

International banks are a case in point. Being globally minded, many of these banks are product oriented and do not hesitate to take courses of action emanating from their headquarters which might sometimes be inconsistent with a long-term perspective towards particular clients.

In the closer business climate typical of a developing country, personal relationships among bankers can be expected to be more relevant and hence relationship banking is likely to predominate. The growing presence of multinational (mostly product oriented) banks in the opening economies of the developing world might be widening the gulf between local and international banks and complicating the possibility of smooth collaboration among creditors.

Key Success Factors

On the basis of these findings, some key factors for successful financial restructurings (with a focus on emerging markets) are now proposed:

Homogeneity of financial claims and creditors

Preferably financial claims should have similar impacts on banks' balance sheets so that unilateral positions are avoided and there are grounds for collective and concerted action. To the extent that business policies and the levels of sophistication among financial claimants are more homogeneous there will be fewer disagreements and a common solution becomes more viable.

Also, the number of claimants is important. The smaller the number of claimants, the easier the negotiations will be and the greater the likelihood of a prompt and satisfactory agreement being reached.

Any highly leveraged firm should avoid having a large number of creditors and look for the profile of its creditors to be as homogeneous as possible in order to lessen the costs of a possible financial restructuring.

Leadership

Considerable effort must be invested in identifying a leader to conduct the negotiations who is respected as a reliable and knowledgeable individual by all creditors. The leader must be accompanied by a competent managerial team and be trusted by all affected parties for his ability to succeed. Credibility stems from the leader's personal history, professional competence and reputation.

Achieving a reasonable degree of cooperation among banks is probably the most important issue for a restructuring leader to be successful.

Lateral relations and implicit contracts

The restructuring leader and his team must be able to act with absolute freedom from lateral relationships, so it is essential to map all personal relationships among the parties involved, be they shareholders, managers or creditors.

Also, the firm's future might depend on breaking an old and costly habit, something that incumbent managers are often reluctant to do: that of having so-called "implicit (unwritten) contracts". If this is the case, reluctant managers must be set aside from the process.

It is so common for lateral relationships and implicit contracts to contaminate restructuring workouts that in most instances the healthiest approach is to set up an independent restructuring team free of these attachments. Regrettably, in view of the closed personal network characterizing the business sector of most developing countries it is often quite difficult to identify a group with these characteristics.

A fair and credible plan

A credible restructuring plan must be prepared. The plan must be based on solid ground and envision the future firm as a cost efficient entity centered on those businesses in which clear competitive advantages can be recognized and nurtured over time.

Projected operating cash flows cannot be too large or too small and must be firmly based. When projected cash flows are too large, financial claimants tend to adopt a wait-and-see attitude. Usually they will not condone any portion of their claims nor accept any equity. When cash flows are too small, financial creditors will not negotiate but simply demand immediate payment even if this implies the firm’s failure and the loss of a substantial portion of their claims.

Financial creditors will always end up with a combination of: a) smaller amounts for either principal or interest or both; b) longer-term debts; and c) some type of equity participation.

When the best outcome is liquidation, the liquidation process must also be carefully designed to capture as much value as possible over time. Conceptually, the objective must be to maximize the present value of asset liquidation.

Everyone is reluctant to put up fresh money, even if this is the optimal way to maximize total value and thus each individual claim. A significant monetary commitment from shareholders together with a credible plan will undoubtedly ameliorate this obstacle. Also, any existent shareholder claim must always remain last in the priority chain.

Shareholders are more likely to maximize their stake when remaining together and are represented by a common leader with a uniform negotiating position. Nonetheless, this is not easy to achieve when having been actively involved in the company key shareholders are part of the problem as well.

Depending on their neutrality, professionalism and objectivity, consultants can also contribute to reinforce credibility. Their influence will depend on their reputation, who is perceived as their client and how free they are from lateral relationships.

The bottom line is that, in every instance, a convincing proposal must be accepted as fair for the great majority of creditors involved.

Early identification of the crisis

Detecting and accepting the imminence of a financial crisis well before it erupts can make all the difference between success and failure. Having enough time allows the preparation of a well-drafted plan and the implementation of the right steps to assure maximum consensus among the affected parties. Also, visualizing the crisis in advance might make it unnecessary to plead for fresh funding, thus steering clear of one of the main barriers in any restructuring process.

Completion of the restructuring in the least possible time

As soon as a company enters into a formal restructuring process its operations start to suffer and the value of the company decreases rapidly. Therefore, achieving results as fast as possible is crucial in order to avoid destroying too much value.

Early identification of the crisis, competent management of the restructuring process under respected leadership, and the design of a good restructuring plan are all key factors that can greatly help to attain results in the shortest possible time.

However, in the highly volatile and unpredictable environment prevalent in most developing countries an agreement as to what is really a viable plan becomes more difficult. This is likely to complicate the negotiations and delay consensus. Hence, it should be expected for higher volatility to translate into greater value destruction.

Financial unification

Another way out of financial distress is to achieve consensus through financial unification, involving a third party who purchases enough claims to manage the process unilaterally. In this manner all conflicts among affected parties are brought to a minimum.

Unfortunately, the scarce development of financial markets and the overwhelming predominance of closely held firms make financial unification a rare option in these countries. The unlikelihood of financial unification probably translates into more negotiating power for financial creditors than would be the case in a developed economy.

A final word: the ultimate proof of the success of a financial restructuring is for the company not to fall into a new crisis for a considerable time (Gilso, Kose & Lang 1990).

Conclusions

As a general conclusion, *ceteris paribus*, it is advisable for firms in emerging markets to have lower and more flexible leverage than their counterparts in the developed world. Consequently, for a given level of debt, financial distress is more likely for firms in developing countries.

Financial distress materializes in emerging country firms not only because of the usual causes found in developed economies (uncompetitiveness; low operational efficiency; bad management; bad investment decisions) but also due to the additional uncertainty stemming from the ever-present volatility in the economic and political atmosphere and the oligopolistic environment that is prevalent in most industries, which expose weaker firms to the threat of aggressive actions from stronger competitors.

The imminence of a financial crisis seems to be recognized later in developing countries by all affected parties, be they the firm's management, its shareholders or its creditors. This attitude might be linked to two possible causes: the lack of stock market discipline for the overwhelming majority of firms, and a frame of mind adapted to an ever-present volatility that might suddenly turn a bad situation into a good one.

Emerging market restructurers avoid legal procedures to resolve financial crises due to cumbersome bankruptcy laws and procedures, the perceived professional incompetence of public officials (which could result in a great destruction of value) and the fear of corruption. Hence, private negotiations usually remain the only practical alternative.

The success of private restructurings hinges critically on the availability of a competent team of managers headed by a respected and trusted leader. It is imperative that this team enjoys complete freedom of action. However, in view of the closed personal network characterizing the business sector of most developing countries it is often difficult to identify the right individuals.

In relation to creditors, the position of the tax authorities and that of financial claimants (i.e. mainly banks) deserve particular mention. In many instances the tax authorities turn out to be in a fragile bargaining position given that, as a general rule, public offices in emerging markets tend to be highly disorganized.

As for financial claimants, it seems that bank accounting regulations and compensation practices motivate bank executives in charge of restructuring processes to turn away from present value maximization and look for a quick recovery of their debts. This practice often results in considerable destruction of value.

Moreover, destruction of value might be accentuated as well for at least two other reasons. First, significant personal relationships among all parties involved tend to be more prevalent in developing countries, given the smaller and more closed business environments prevailing in these nations. This can impair the objectivity of the restructuring plan.

And second, in the highly volatile and unpredictable environment prevalent in many developing countries agreement on a restructuring does not come easily. This is likely to complicate the negotiations and delay consensus.

Finally, underdevelopment of financial markets and the preponderance of closely held firms decrease the likelihood of financial unification. This probably results in more negotiating power for financial creditors.

It is an open question and an opportunity for empirical research to assess to what extent these preliminary conclusions are applicable to emerging countries in general.

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