

Corporate Financial Distress

This page intentionally left blank

Corporate Financial Distress: Restructuring and Turnaround

BY

DR ALBERTO TRON

Bocconi University, Italy



United Kingdom – North America – Japan – India – Malaysia – China

Emerald Publishing Limited
Howard House, Wagon Lane, Bingley BD16 1WA, UK

First edition 2021

Copyright © 2021 Emerald Publishing Limited

Reprints and permissions service

Contact: permissions@emeraldinsight.com

No part of this book may be reproduced, stored in a retrieval system, transmitted in any form or by any means electronic, mechanical, photocopying, recording or otherwise without either the prior written permission of the publisher or a licence permitting restricted copying issued in the UK by The Copyright Licensing Agency and in the USA by The Copyright Clearance Center. Any opinions expressed in the chapters are those of the authors. Whilst Emerald makes every effort to ensure the quality and accuracy of its content, Emerald makes no representation implied or otherwise, as to the chapters' suitability and application and disclaims any warranties, express or implied, to their use.

British Library Cataloguing in Publication Data

A catalogue record for this book is available from the British Library

ISBN: 978-1-83982-981-9 (Print)

ISBN: 978-1-83982-980-2 (Online)

ISBN: 978-1-83982-982-6 (Epub)



ISOQAR
REGISTERED

Certificate Number 1985
ISO 14001

ISOQAR certified
Management System,
awarded to Emerald
for adherence to
Environmental
standard
ISO 14001:2004.



INVESTOR IN PEOPLE

Table of Contents

List of Tables and Figures	<i>ix</i>
About the Author	<i>xiii</i>
Preface	<i>xv</i>
Chapter 1 Corporate Distress and Financial Equilibrium: Genesis and Prognosis	<i>1</i>
1. Introduction and Background	<i>1</i>
2. Defining Corporate Distress: From Decline to Crisis	<i>4</i>
3. Crisis Factors: Identification, Handling and Governance	<i>7</i>
3.1 The Time Factor	<i>7</i>
3.2 Internal Causes	<i>8</i>
3.2.1 Inefficiency Crisis	<i>8</i>
3.2.2 Overcapacity Crisis	<i>9</i>
3.2.3 Product-related Crisis	<i>9</i>
3.2.4 Crisis Related to Lack of Planning and Innovation	<i>9</i>
3.3 External Causes: A Holistic Vision	<i>9</i>
4. Business Distress: The Importance of the Financial Structure Equilibrium	<i>11</i>
4.1 Financial Requirements and Their Constant Variability	<i>11</i>
4.2 Interdependence and Complementarity of the Company's Different Sources of Financing	<i>14</i>
4.3 The Choice of the Most Convenient Financial Structure and 'Leverage'	<i>18</i>
4.4 Assessment of the Financial Equilibrium	<i>22</i>

Chapter 2	Corporate Recovery Plans between Value Protection and Management Turnaround	25
	1. Corporate Financial Distress and Continuity: The Protection of Business Value. National, Economic and Legal Dimensions	25
	2. The Feasibility of a Recovery Business Plan: Best Practice Principles (CNDCEC)	32
	3. Turnaround Strategy of a Financially Distressed Company	37
	4. Developing a Business Turnaround Plan	43
Chapter 3	Financial and Operational Business Turnarounds: Execution and Monitoring Complexity	51
	1. The Recovery Project, Its Complexity and Execution	51
	2. Company Organisation: A Strategic Resource in the Recovery Process	55
	3. Organisational Recovery as an Element of the Action Plan	56
	4. Feasibility of the Recovery Financial Plan as a Result of a Correct Execution Process (Deployment)	60
	5. The Monitoring of the Recovery Business Plan	64
Chapter 4	Common Characteristics of Firms in Financial Distress and Prediction of Bankruptcy or Recovery: An Empirical Research Carried out in Italy	67
	1. Overview of Corporate Financial Distress and Bankruptcy (with a Special Focus on Italy) and ‘Early Warning’ Signs	67
	2. The Company Recovery in Theoretical and Empirical Research Work	68
	3. An Empirical Analysis by the University of Pisa in 2012 on the Correlation between Financial Flows and Economic Performance (as a Predictive Element of the Crisis)	69
	4. Empirical Analysis by the University of Pisa in 2013 on: (a) Cash Flow and Correlations with the Economic Performance of Italian Listed Companies and (b) Predictive Capacity of Past Operating Cash Flows and Profits over Future Operating Cash Flows and Profits	73

5. Corporate Crises, Weak Signals and Debt Restructuring: An Empirical Analysis in 2014–2015 by Bocconi University and SDA Bocconi	79
6. Business Administrative Systems (BAS) and Bankruptcy Financial Distress (Based on the Observatory on Corporate Crisis – OCI Survey (2011))	81
6.1 Reorganisation Strategies and Administrative Systems	82
6.2 Business Administrative Systems in Financial Distress Situation	84
6.3 Results	85
7. Innovative Empirical Research by Bocconi University and Parthenope University in 2018 on Corporate Recovery over a 10-year Observation Period (2007–2016)	88
8. Empirical Research for the Predictive Ability of Cash Flows for Measuring Firm Performance (2020)	94
8.1 Data Source	94
8.2 Regression Model	95
8.3 Results	95
9. Conclusions	97

Chapter 5 Business Case: The Financial Restructuring of the ‘Alpha’ Group (2013–2015)	101
1. The ‘Alpha’ Group and Its Business Model Over Time	101
2. The Reference Market and Sector	102
3. Causes of the Alpha Group Crisis	105
3.1 Exogenous Causes	106
3.2 Endogenous Causes	107
4. Recovery Actions: The 2013–2015 Financial and Strategic Recovery Plan	109
5. The Proposal of a Financial Intervention	114
6. A Successful Turnaround: Overcoming the Financial Crisis Situation of the Alpha Group	118
7. The Achievement of the Commercial, Economic, Equity and Financial Objectives of the Recovery Plan during the Turnaround Period	118

viii Table of Contents

8. The Group's Performance in the Recovery Phase (2013–2015)	119
9. The Prospective Financial Balance: Guidelines and Strategic Objectives of the Post Turnaround Plan (2016–2018)	128
10. From Financial Crisis to Value Creation: The Search for a Partner to Foster International Growth	136
11. Conclusions	136
References	139
Index	161

List of Tables and Figures

Chapter 1

Table 1.1.	Positive Margin Structure Hypothesis.	15
Table 1.2.	Hypothesis of Positive Revolving Fund.	15
Table 1.3.	Assumptions of Negative Net Working Capital (NWC).	15

Chapter 2

Table 2.1.	Italian Stock Exchange (Borsa Italiana) Business Plan Guidelines.	33
Table 2.2.	Analysis of the Financial Situation.	49
Table 2.3.	Statement of Liquidity.	49

Chapter 4

Table 4.1.	Analysis of the Cash Flow Statements of the Sample Companies.	70
Table 4.2.	Correlations between Financial Flows and Examined Profitability Ratios.	71
Table 4.3.	Correlations Highlighted by the University of Pisa/ ANDAF's Research.	72
Table 4.4.	Correlations between Working Capital Flow (2004–07) and Average Values of Profitability and Market Value Indices (2008–2009).	73
Table 4.5.	Correlations between Net Working Capital (2004–2007) and Profitability Indices (2008–2009).	73
Table 4.6.	Correlation between Net Working Capital (2004–2007) and Average Profitability Indices (2010–2011).	74

Table 4.7.	Correlation between Net Working Capital (2004–07) and Precise Profitability Indices (2010–2011).	74
Table 4.8.	Analysis of the Predictive Ability of Operating Cash Flow and Profits in Relation to Operating Cash Flow in the Period 1998–2004. Dependent Variable: Operating Cash Flow at Time ‘t’.	76
Table 4.9.	Analysis of the Predictive Ability of Operating Cash Flow and Profit in Relation to Operating Cash Flow in the Period 2005–2011. Dependent Variable: Operating Cash Flow at Time ‘t’.	77
Table 4.10.	Analysis of the Predictive Ability of Operating Cash Flow and Profits in Relation to Operating Cash Flow in the Period 1998–2004. Dependent Variable: Net Profit at Time ‘t’.	77
Table 4.11.	Analysis of the Predictive Ability of Operating Cash Flow and Profits in Relation to the Operating Cash Flow in the Period 2005–2011. Dependent Variable: Net Profit at Time ‘t’.	78
Table 4.12.	Variable Description.	86
Table 4.13.	Headquarters of the Companies Included in the Sample.	89
Table 4.14.	Correlation Analysis and Following Regression Analysis Carried out on the Selected Sample.	92
Table 4.15.	Correlation Analysis of Dependent and Independent Variables.	96
Chapter 5		
Table 5.1.	Customer Segments.	104
Table 5.2.	Details of Consolidations by Company and Credit Institutions.	115
Table 5.3.	Past Due Items.	117
Table 5.4.	Credit Lines.	117
Table 5.5.	Recovery Actions and Objectives Achieved.	120
Table 5.6.	Evolution of NFP 2013–2015 Plan vs Real.	125
Table 5.7.	Characteristic KPI-Ratio 2013–2015 Plan vs Real.	126

Table 5.8.	Sensitivity and Stress Test Plan 2016–2018 Analysis Criteria.	134
Table 5.9.	Sensitivity and Stress Test Plan 2016–2018 Analysis.	135
Chapter 1		
Figure 1.1.	The Four Stages of Crisis according to the Traditional Approach (Guatri, 1995).	6
Figure 1.2.	The Path to the Crisis.	6
Chapter 2		
Figure 2.1.	Business Plan Structure.	46
Chapter 3		
Figure 3.1.	The Turnaround Road Map.	54
Figure 3.2.	KPI Scorecard Monitoring.	59
Figure 3.3.	Sensitivity Analysis and Determination of ‘Delta-Performance’ Scenarios.	62
Figure 3.4.	Deployment Action Plan.	63
Figure 3.5.	Monitoring Framework.	65
Chapter 4		
Figure 4.1.	Enabling Factors of the Processes of Strategic and Operative Turnaround.	83
Figure 4.2.	ROS Trend (%) for the Companies Included in the Different Samples.	90
Figure 4.3.	ROA Trend (%) for Companies Included in the Different Samples.	91
Figure 4.4.	D/E Trend for the Companies Included in the Different Samples.	91
Figure 4.5.	Debt/EBITDA Trend for the Companies Included in the Different Samples.	93
Chapter 5		
Figure 5.1.	2007–2011: Market Trend by Product.	103
Figure 5.2.	Market Dimensions.	104
Figure 5.3.	Market Dimensions.	104

Figure 5.4.	Trend in Production Value.	106
Figure 5.5.	EBITDA Margin Evolution 2010–2012.	109
Figure 5.6.	Cost Savings 2010–2012.	109
Figure 5.7.	NFP/EBITDA, NFP/NE (2010–2012).	110
Figure 5.8.	Causes of the Crisis, Recovery Actions, Operational Objectives, Strategic Objectives.	111
Figure 5.9.	Effects of Recovery Actions on Beta’s Performance.	112
Figure 5.10.	KPI 2012–2015.	114
Figure 5.11.	Details of Consolidations by Company and Credit Institutions.	116
Figure 5.12.	Staff 2013–2015 (Recovery Business Plan vs Real).	120
Figure 5.13.	Personnel Cost Impact 2013–2015 Recovery Business Plan vs Real.	121
Figure 5.14.	Turnover Trend Beta 2013–2015	121
Figure 5.15.	Net Revenues 2013–2015 Plan vs Real.	122
Figure 5.16.	Economic Performance 2013–2015 Plan vs Real.	123
Figure 5.17.	EBITDA Trend 2013–2015 Recovery Business Plan (RBP) vs Real.	124
Figure 5.18.	Revenues, EBITDA and Cumulated Net Result 2013–2015 Recovery Business Plan vs Real.	124
Figure 5.19.	Evolution of the NFP 2013–2015.	125
Figure 5.20.	NFP/PN – NFP/EBITDA 2013–2015 Plan vs Real.	126
Figure 5.21.	Various Index Relating to the RBP vs Actual (see Previous Table 5.7).	127
Figure 5.22.	Financial Covenant 2013–2015 Plan vs Real.	128
Figure 5.23.	Alpha Group – ‘Z-Score PMI’ Distress Risk Index.	129
Figure 5.24.	Alpha Group – ‘Z-Score PMI’ Distress Risk Index 2010 to Forecast 2018.	130
Figure 5.25.	EBITDA Bridge 2015–2018.	131
Figure 5.26.	PFN Trend 2012–2018E.	132
Figure 5.27.	PFN/EBITDA 2012–2018E.	132
Figure 5.28.	NWC Trend.	132

About the Author

Professor Alberto Tron

Since 2016, Alberto Tron has been a Professor of Corporate Finance at the University of Milan, Bocconi.

From 2006 to 2019, he was Professor of Accounting and Business Economics at the University of Pisa.

Over his professional and university career, he has co-authored 13 books, wrote more than 50 publications in national and international journals and has been a speaker at numerous conferences on corporate finance, financial market law and regulation, accounting and financial reporting issues linked to supervisory bodies, auditing and business crisis management.

Member of ADEIMF (Associazione dei Docenti di Economia degli Intermediari e dei Mercati Finanziari e Finanza Aziendale – the Academy Association of Financial Markets and Corporate Finance Professors) and SIDREA (Società Italiana Docenti di Ragioneria ed Economia Aziendale – the Academy Society of Business Administration Professors).

Member of ANDAF (Associazione Nazionale Direttori Amministrativi e Finanziari – the National Association of Chief Financial Officers) and Chairman of ANDAF's Financial Reporting Standards Committee.

Member of the working groups on Italian and International accounting standards and financial instruments at the Organismo Italiano di Contabilità (OIC – the National Accounting Standard Setter).

Member of working groups on Italian valuation standards at Organismo Italiano di Valutazione (OIV – the Italian valuation standard setter member of IVS).

Expert member of the Company Valuations Committee and Non Performing Loans Committee set up by the Consiglio Nazionale dei Dottori Commercialisti e degli Esperti Contabili – CNDCEC (the National Council of Chartered Accountants).

This page intentionally left blank

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
Alberto Tron