Corporate Financial Distress

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Corporate Financial Distress: Restructuring and Turnaround

BY

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Preface

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

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

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

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

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

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

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

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

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

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

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

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