FINANCIAL Restructuring

A company's financial condition could be impaired for variety of reasons. When outcome does not follow plans, the financial conditions deteriorate. Weakening financial conditions shrinks the repayment capacity. Worsening repayment capacity reduces borrowing capacity. Reduced borrowing capacity may stop the progress of future expansion plans. In such circumstances flexibility in financial structure is indispensable need of present time.

An appropriate financial structure is crucial if growth of the business is to be sustained. The financial structure needs to provide for maximum flexibility, apart from the need for cash flows, working capital, and a return on investment. A company also needs to build in protection against risks, such as interest and exchange rate fluctuations, seasonal economic changes, slow paying debtors and illness or premature death of key players, etc.

An optional financial structure depends on:

- Cost of debt and equity
- Risk and return profile of the industry
- Size of the company
- Management control
- Flotation cost

Before finalising the financial structure, the following points need to be considered:

➢ Debt benefits companies by providing a tax advantage, thereby making the cost of debt lower than that of equity. However, if the return of the company is not assured, then a higher level of debt can prove to be costlier than equity. Hence, debt is a double-edged sword. A proper mix of debt and equity is essential. The size of the company and the nature of the business can also determine the financial structure – the greater the size, the higher could be the debt equity ratio.

➢ Management control is also a crucial factor in deciding the fate of the company, as diversified control may lead to unconformity of decisions, loosing management control over the company etc. whereas unified control or majority management control provides centric decision-making power.

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Indicators of poor financial health

The following are indicators that suggest poor financial health:

Quantitative indicators:

- ❖ Decreasing interest cover
- ❖ Worsening debt equity ratio
- ❖ Decreasing Debt Service Coverage Ratio (DSCR)
- ❖ Sub optimal current ratio
- ❖ Decreasing earnings

Qualitative indicators:

- ❖ Asset-liability mismatch
- ❖ Build-up of current liabilities
- ❖ Loss making subsidies

Reasons for poor financial structure

A company has to make proper decisions regarding the appropriate structure. However, for various reasons, even the most carefully considered decisions could fail to achieve the desired results.

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There are basically two reasons for a poor financial structure:
1. Financial reasons, and
2. Operational reasons

Financial Reasons:

- Higher than prudent level of leveraging for the industry
- Project cost overrun
- Funds diversion out of the project
- Funding of long-term assets with short-term funds
- Bunching debt servicing obligations

Operational reasons:

- New project coinciding with a downturn in the industry
- Operating profits insufficient to serve debt
- Very high level of receivables/ inadequate debtor recovery

Restructuring objectives

Achieve optimal capital structure in line with the earning capacity of the enterprise, i.e. there should exist a proper debt equity mix that is best suited for the company with respect to its cash flows.

Ensure that cash flows are sufficient to meet financial obligations with a margin of safety. Enable the company to focus on the new business plan. Financial restructuring enables the company to achieve an optimal capital structure. It helps in maintaining its cash flow, thus enabling the company to focus on new business plans.

Restore investors'/creditors'/ other stake-holders' faith in the

company and its management. The restructured company should be in a better position to meet its obligations on time. Create a platform for long-term business growth to enhance shareholders' value.

Restructuring Options

Financial restructuring involves restructuring the assets and liabilities of corporation, in line with their cash flow needs, in order to promote efficiency, support growth, and maximise the value to shareholders, creditors and other stakeholders. Financial restructuring may mean refinancing at every level of capital structure, including:

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- Securing asset-based loans (accounts receivables, inventory, and equipment)
- Securing mezzanine and subordinated debt financing
- Securing institutional private placement of equity
- Achieving strategic arrangements or merger
- Sale of non core assets
- Obligation assets on lease
- Equity infusion
- Dilution of equity
- Tax incentives by Central/State Govt.
- Concession/freezing of power rates by State Electricity Board
- Soft loans from State Development institutions/ Central/ State Govt.

Process of financial restructuring

1. Operations, financial and legal review:

- Review key project agreements
- Analyse the debt profile, credit facilities and investments, and debt service obligations
- Review/analyse historical operational performance and financials
- Analyse sales projections and revenues
- Prepare operational and financial forecasts
- Construct a comprehensive financial model

2. Assess stakeholders' objectives:

Lender's Objectives

- Lenders' financial conditions and positions
- Conflicting interest of various lenders
- Interest of term lender and working capital provider

Shareholders' objectives

- Maintenance of operational control
- Equity issuance
- Likelihood and form of additional support

Company's objectives

- All short-term and long-term operational and strategic plans should be achieved
- Management control and flexibility in operations

3. Assess restructuring options:

Short-term goals

- Evaluation current liquidity and prospects
- Advise on actions to preserve/enhance liquidity

Long-term goals

- Determine sustainable capital structure that enables company to:
- Meet its financial obligations
- Achieve in business objectives including growth
- Attract additional capital

While assessing the restructuring options (as discussed above), short term and long term goals are to be taken into consideration. One needs to prioritise restructuring options by analysing impact on shareholders, company and creditors.

4. Formulate restructuring plan:

- Develop initial restructuring plan
- Prepare information memorandum giving details of restructuring plan
- Present/sell the plan to creditors
- Based on creditors' reaction refine Restructuring Plan to address the needs of lenders in the context of shareholders and company objectives

A company has to make proper decisions regarding the appropriate structure. However, for various reasons, even the most carefully considered decisions could fail to achieve the desired results.

5. Negotiations:

- Identify 'key' creditors who can serve as opinion leaders and prioritise contact with them
- Interface with creditors' advisors
- Meet with banks individually and on a collective basis
- Prepare and present road-shows as appropriate
- Assist management in negotiation
- Co-ordinate meetings for negotiations

6. Documentation:

- Preparation of final documents as negotiated
- Getting approval and filing
- Implementation & review

Conclusion

Impact of rapid and two fold movement of exchange rate, volatile inflation, fluctuating crude oil price, global factors etc. on industry is rising with the opening up of economy. Demand supply equation simply in domestic arena does not work. Heavy demand or supply in other countries can prove to be doom or boom for domestic player. And so it, the business vulnerable to variety of risks. With the rise in the risk factor need for financial prudence and financial restructuring has gone up rapidly. Last three years have witnessed drastic fall in rate of interest. In this phase industry has also learned the lesson that arranging finance is not only the issue. Arranging finance in appropriate mix of debt and equity at flexible terms has gathered greater significance. ■

Invitation for contributing articles

To put the entire gamut of subjects related with the Finance Bill 2005 in perspective, we have decided to bring March 2005 issue of *The Chartered Accountant* on the theme 'Union Budget 2005-06'. Experts in the field are invited to contribute articles for the same.

The articles, not exceeding 3,500 words each, should reach us by **March 2, 2005** along with passport size photograph, e-mail, postal address and contact numbers of the authors. The articles can be sent to us by e-mail at nadeem@icai.org/ ebsecretariat@icai.org or by post (two manuscripts along with a soft copy) to – **The Editor,** The Chartered Accountant, Journal Section, ICAI, PO Box 7100, New Delhi – 110002

The theme for the April, 2005 issue the journal is: **Fraud Detection and Audit**