



City Research Online

City, University of London Institutional Repository

Citation: Lai, C.C. (1997). Corporate restructuring and turnaround : an exploratory study of the determinants and effectiveness of corporate restructuring strategies by troubled UK firms. (Unpublished Doctoral thesis, City University London)

This is the accepted version of the paper.

This version of the publication may differ from the final published version.

Permanent repository link: <https://openaccess.city.ac.uk/id/eprint/8274/>

Link to published version:

Copyright: City Research Online aims to make research outputs of City, University of London available to a wider audience. Copyright and Moral Rights remain with the author(s) and/or copyright holders. URLs from City Research Online may be freely distributed and linked to.

Reuse: Copies of full items can be used for personal research or study, educational, or not-for-profit purposes without prior permission or charge. Provided that the authors, title and full bibliographic details are credited, a hyperlink and/or URL is given for the original metadata page and the content is not changed in any way.

City Research Online:

<http://openaccess.city.ac.uk/>

publications@city.ac.uk

DX201984

**CORPORATE RESTRUCTURING AND TURNAROUND:
AN EXPLORATORY STUDY OF THE DETERMINANTS AND
EFFECTIVENESS OF CORPORATE RESTRUCTURING
STRATEGIES BY TROUBLED UK FIRMS**

By

Chee Chuen Lai

Submitted for the degree of
Doctor of Philosophy

City University, London.

The research was conducted at:

**City University Business School
Department of Business Studies**

March 1997

Table of Contents

List of Tables	I
List of Figures	VII
Acknowledgements	XIII
Declaration	XIV
Abstract	XV
Chapter 1. RESEARCH OBJECTIVES	1
1.1 Introduction	1
1.2 Alternative perspectives on financial performance	6
1.3 Corporate restructuring framework	7
1.4 Determinants of restructuring strategy choice	8
1.5 Effectiveness of restructuring strategies and corporate turnarounds	10
1.6 Research objectives and contribution	11
1.7 Outline of thesis	14
Chapter 2. ALTERNATIVE PERSPECTIVES ON FINANCIAL PERFORMANCE DECLINE	17
2.1 Introduction	17
2.3 Financial performance measures	17
2.3.1 Accounting-based performance measures	18
2.3.2 Debt/bankruptcy-based performance measures	24
2.3.3 Stock returns-based performance measures	25
2.3.4 Criticism of stock return measures	27
2.4 Financial decline models	32
2.5 Performance decline research framework	34
2.6 Choice of decline and financial performance measures	38
2.7 Corporate responses to performance decline	40
Appendix 2.1: Review of decline-related studies: Definitions of Distress	41
Appendix 2.2: UK Insolvency Procedures	50

Chapter 3.	CORPORATE RESTRUCTURING FRAMEWORK	58
3.1.	Introduction	58
3.2	Managerial restructuring	60
3.3	Operational restructuring	61
3.4	Asset restructuring	63
3.4.1	Asset divestment	64
3.4.2	Asset investment	66
3.5	Financial restructuring	68
3.5.1	Equity-based financial restructuring	68
3.5.2	Debt-based financial restructuring	69
3.6	Capital reconstruction	71
3.7	Summary of corporate restructuring strategies	72
	Appendix 3.1 : Review of distress related studies: Restructuring strategies	77
Chapter 4.	DETERMINANTS OF RESTRUCTURING STRATEGY CHOICE: - THEORY AND EMPIRICAL EVIDENCE . .	83
4.1	Introduction	83
4.2	Agency monitoring mechanisms	84
4.2.1	Impact of lender monitoring on managerial choice . . .	87
4.2.2	Impact of ownership structure on managerial choice . .	90
4.2.3	Impact of corporate governance structure on managerial choice	96
4.2.4	Summary of agency monitoring mechanisms and their impact on corporate restructuring	100
4.3	Impact of agency control mechanisms on specific restructuring strategy choice	105
4.3.1	Effects of stakeholder dominance on specific strategy choice	107
4.3.2	Combined impact of stakeholders on specific strategy choice.	113
4.4	Contextual factors	116
4.4.1	Causes of performance decline	116
4.4.2	Severity of decline	117
4.4.3	Firm size	118
4.4.4	Industry condition	118
4.4.5	Economic condition	119
4.5	Summary of determinants of restructuring strategy choice . .	120
	Appendix 4.1 : Review of decline-related studies: Causes of decline and turnaround strategies	122

Chapter 5.	EFFECTIVENESS OF RESTRUCTURING STRATEGIES AND CORPORATE TURNAROUND: EMPIRICAL EVIDENCE	127
5.1	Introduction	127
5.2	Deficiencies in existing measures of turnaround strategy effectiveness	128
5.3	Strategy effectiveness measures used in this research	130
5.4	Strategy effectiveness: Shareholder wealth impact of strategy announcement	132
5.4.1	Effectiveness of managerial restructuring	132
5.4.2	Effectiveness of operational restructuring	134
5.4.3	Effectiveness of asset restructuring	135
5.4.4	Effectiveness of financial restructuring	136
5.4.5	Summary of perspectives on shareholder wealth impact of restructuring strategies	139
5.5	Strategy effectiveness: Impact of restructuring strategy and control variables on recovery from performance decline	142
5.6	Impact of implementation on effectiveness of restructuring strategies	144
5.7	Summary	146
Chapter 6	METHODOLOGY AND DATA: POOR PERFORMING AND DISTRESSED SAMPLES	148
6.1	Introduction	148
6.2	Methodology	150
6.2.1	Definition of poor performance and financial distress	150
6.2.2	Testing for the impact of stakeholder dominance	152
6.2.3	Testing for the combined impact of agency and control variables on strategy choice	153
6.2.4	Testing for strategy effectiveness: Event study of strategy announcements	154
6.2.5	Testing for impact of strategy and control variables on corporate recovery	155
6.3	Definitions of dependent variables	157
6.3.1	Testing for the combined impact of agency and control variables on strategy choice	157
6.3.2	Testing for the impact of strategy and control variables on corporate recovery	163
6.4	Definitions of explanatory variables	165
6.4.1	Testing for the combined impact of agency and control variables on strategy choice	165
6.4.2	Testing for the impact of intensity of strategy and control variables on corporate recovery	168

6.5	Data	171
6.5.1	Poor performing firms sampling	171
6.5.2	Distressed firms sampling	172
6.6	Sample characteristics	174
6.6.1	Poor performing firms	174
6.6.2	Distressed firms	194
	Appendix 6.1: Event study methodology	209
Chapter 7.	DETERMINANTS OF RESTRUCTURING STRATEGY	
	CHOICE OF POORLY PERFORMING FIRMS: RESULTS	
	OF EMPIRICAL ANALYSIS	217
7.1	Introduction	217
7.2	Impact of stakeholder dominance on turnaround strategy choice	217
7.3	Impact of individual agency monitoring mechanisms on turnaround strategy choice: Logit regressions	224
7.3.1	Strategy choices and their determinants in the decline year	225
7.3.2	Strategy choices and their determinants: Year after decline	228
7.3.3	Strategy choices and their determinants: Second year after decline	231
7.3.4	Strategy choices and their determinants: A three-year summary	234
7.3.5	Joint impact of explanatory variables on strategy choice: A three-year summary	239
7.4	Impact of lender and ownership types on restructuring strategy choice	243
7.4.1	Impact of lender types	244
7.4.2	Impact of ownership types	247
7.4.3	Resulting impact on other agency and control variables	247
7.4.4	Resulting impact on coalitions of stakeholders	248
	Appendix 7.1: Logistic regression of restructuring strategies on agency and control variables: Decline year [Individual variables] ..	254
	Appendix 7.2: Logistic regression of restructuring strategies on agency and control variables: Decline year+1 [Individual variables]	255
	Appendix 7.3: Logistic regression of restructuring strategies on agency and control variables: Decline year+2 [Individual variables]	256

Chapter 8.	EFFECTIVENESS OF RESTRUCTURING STRATEGIES BY POORLY PERFORMING FIRMS: RESULTS OF EMPIRICAL ANALYSIS.	257
8.1	Introduction	257
8.2	Financial characteristics of recovery and non-recovery firms	258
8.3	Frequency and timing of restructuring	261
8.4	Intensity of restructuring	264
8.5	Shareholder wealth impact of restructuring strategies	269
8.6	Restructuring and corporate turnaround	281
8.7	Summary and conclusions	286
Chapter 9.	DETERMINANTS AND EFFECTIVENESS OF RESTRUCTURING STRATEGIES BY DISTRESSED FIRMS: RESULTS OF EMPIRICAL ANALYSIS	291
9.1	Introduction	291
9.2	Impact of stakeholder dominance on turnaround strategy choice	292
	9.2.1 Lender dominance	296
	9.2.2 Manager and dual-CEO dominance	297
	9.2.3 Blockholder dominance	297
	9.2.4 Board dominance	298
9.3	Impact of individual agency monitoring mechanisms on restructuring strategy choice	298
	9.3.1 Strategy choices and their determinants in the distress year	299
	9.3.2 Strategy choices and their determinants- Year after distress	301
	9.3.3 Strategy choices and their determinants: Second year after distress	305
	9.3.4 Strategy choices and their determinants: A three year summary	307
9.4	Impact of lender and ownership types on restructuring strategy choice	318
	9.4.1 Impact of lender types	319
	9.4.2 Impact of ownership types	322
	9.4.3 Impact of other agency and control variables	323
	9.4.4 Joint impact of agency and control variables	324
9.5	Effectiveness of restructuring strategies for distressed firms	327
	9.5.1 Financial characteristics of recovery and non-recovery firms	329
	9.5.2 Frequency and timing of restructuring	331
	9.5.3 Intensity of restructuring	333

9.5.4	Restructuring and corporate turnaround of distressed firms	336
9.6	Summary and conclusion	339
Appendix 9.1:	Logistic regression of restructuring strategies on agency and control variables: Distress year [Individual variables] ..	342
Appendix 9.2:	Logistic regression of restructuring strategies on agency and control variables: Distress year+1 [Combined variables]	343
Appendix 9.3:	Logistic regression of restructuring strategies on agency and control variables: Distress year+2 [Combined variables]	344
Chapter 10.	DETERMINANTS AND EFFECTIVENESS OF RESTRUCTURING STRATEGIES: A COMPARISON BETWEEN POORLY PERFORMING AND DISTRESSED FIRMS	345
10.1	Introduction	345
10.2	Impact of stakeholder dominance and restructuring strategy choice	346
10.3	Impact of agency and control variables on restructuring strategy choice	350
10.3.1	Impact of lenders	350
10.3.2	Impact of owners	355
10.3.3	Impact of corporate governance	356
10.3.4	Impact of control variables	357
10.4	Joint impact of agency and control variables on restructuring strategy choice	360
10.5	Effectiveness of restructuring strategies	367
10.6	Summary and conclusions	370
Chapter 11.	CONCLUSIONS AND IMPLICATIONS	374
11.1	Introduction	374
11.2	Determinants of restructuring strategy choice	375
11.3	Effectiveness of restructuring strategies and corporate turnaround	384
11.4	Determinants and effectiveness of restructuring strategy choice: A comparison between poorly performing and distressed firms	386
11.5	Issues for further research	390
BIBLIOGRAPHY		392

List of Tables

<u>Number</u>	<u>Title</u>	<u>Page No.</u>
3.1	Restructuring by 46 large US firms in response to performance decline during the period 1980-1987.	73
3.2	Corporate Restructuring Strategies: A Summary	74
4.1	Agency monitoring incentives and corporate restructuring	101
4.2	Stakeholder dominance and specific restructuring strategy choice	108
4.3	Impact of lenders, ownership and governance on restructuring strategy choice	114
5.1	Summary of the effectiveness of restructuring strategies	140
6.1	Definition of restructuring strategies	159
6.2	Definition of agency monitoring and control variables	166
6.3	Definition of intensity of restructuring strategies	169
6.4	Descriptive statistics of sample firms' financial performance [Poor performance sample]	175
6.5	Descriptive statistics for independent variables [Poor performance sample]	180
6.6	Descriptive statistics for dependent variables [Poor performance sample]	183
6.7	Pearson correlation coefficients among the explanatory and control variables [Poor performance sample]	187
6.8	Financial status two years post-decline [Poor performance sample]	190
6.9	Descriptive statistics of sample firms' post-decline financial performance [Poor performance sample]	193

<u>Number</u>	<u>Title</u>	<u>Page No.</u>
6.10	Descriptive statistics of sample firms financial performance [Distressed sample]	195
6.11	Descriptive statistics for agency and dependent variables [Distressed sample]	198
6.12	Restructuring strategy choice: A comparison between poorly performing and distressed samples	202
6.13	Pearson correlation coefficients among the explanatory and control variables [Distressed sample]	204
6.14	Financial status two years after distress [Distressed sample]	206
7.1	Stakeholder dominance restructuring strategy choice [Poor performance sample]	220
7.2	Impact of stakeholder dominance on restructuring strategy choice [Poor performance sample]	222
7.3	Logistic regression of restructuring strategies on agency and control variables: Decline year [Poor performance sample]	226
7.4	Logistic regression of restructuring strategies on agency and control variables: Decline year +1	229
7.5	Logistic regression of restructuring strategies on agency and control variables: Decline year +2	232
7.6	Summary of the effect of each explanatory variable on the choice of restructuring strategy [Poor performance sample]	235
7.7	Predicted and actual impact of lender, ownership and governance on restructuring strategy choice [Poor performance sample]	236
7.8	Joint impact of explanatory variables on individual restructuring strategy choice [Poor performance sample]	240

<u>Number</u>	<u>Title</u>	<u>Page No.</u>
7.9	Summary of the effect of each explanatory variable on the choice of restructuring strategy: Individual variables [Poor performance sample]	245
7.10	Joint impact of explanatory variables on individual restructuring strategy choice: Individual variables [Poor performance sample]	249
8.1	Financial characteristics of recovery and non-recovery firms [Poor performing sample]	259
8.2	Frequency and timing of restructuring strategies by recovery and non-recovery firms [Poor performance sample]	262
8.3	Intensity of restructuring by recovery and non-recovery firms [Poor performance sample]	266
8.4	Frequency of announcements to the London Stock Exchange by recovery and non-recovery firms for two post-decline years	271
8.5	Cumulative abnormal returns surrounding announcement of restructuring in the two years post-decline	274
8.6	Summary of shareholder wealth impact of strategy announcements	279
8.7	Logit and OLS regressions of recovery and two year cumulative stock returns ranking in the market post-decline, on intensity of restructuring strategies and control variables	283
9.1	Stakeholder dominance and restructuring strategy choice [Distressed sample]	293
9.2	Impact of stakeholder dominance on restructuring strategy choice [Distressed sample]	295
9.3	Logistic regression of restructuring strategies on agency and control variables: Distress year	300
9.4	Logistic regression of restructuring strategies on agency and control variables: Distress year +1	303

<u>Number</u>	<u>Title</u>	<u>Page No.</u>
9.5	Logistic regression of restructuring strategies on agency and control variables: Distress year +2	306
9.6	Summary of the effect of each explanatory variable on the choice of restructuring strategies [Distressed sample]	308
9.7	Predicted and actual impact of lender, ownership and governance on restructuring strategy choice [Distressed sample]	310
9.8	Joint impact of explanatory variables on individual restructuring strategy choice [Distressed sample]	315
9.9	Summary of the effect of each explanatory variable on the choice of restructuring strategies: Individual variables [Distressed sample]	320
9.10	Joint impact of explanatory variables on individual restructuring strategy choice: individual variables [Distressed sample]	325
9.11	Financial characteristics of recovery and non-recovery firms [Distressed sample]	330
9.12	Frequency and timing of restructuring strategies by recovery and non-recovery firms [Distressed sample]	332
9.13	Intensity of restructuring by recovery and non-recovery firms [Distressed sample]	334
9.14	Logit and OLS regressions of recovery and change in Z score two year post distress from the pre-distress year, on intensity of restructuring strategies and control variables	338
10.1	Stakeholder dominance and restructuring strategy choice: A comparison between poor performance and distressed samples	347
10.2	Impact of each explanatory variable on the choice of restructuring strategies: A comparison between poor performance and distressed samples	351

<u>Number</u>	<u>Title</u>	<u>Page No.</u>
10.3	Joint impact of explanatory variables on individual restructuring strategy choice: A comparison between poor performance and distressed samples	361
10.4	Logit and OLS regressions of recovery on intensity of restructuring strategies and control variables: A comparison between poor performance and distressed samples	368

List of Figures

<u>Number</u>	<u>Title</u>	<u>Page No.</u>
2.1	Types of distress	35
2.2.	Public insolvencies amongst listed UK firms: 1987-1993	57
4.1	Determinants of restructuring strategy choice framework	84
6.1	Sample firms pre- and post-decline median annual and cumulative returns: Poor performance sample	178
6.2	Recovery and non-recovery firms cumulative log annual returns from two year prior to two year post decline: Poor performance sample	192

Acknowledgements

I am immensely grateful to my supervisor, Professor Sudi Sudarsanam, for all the help and guidance over the last three and half years.

I would also like to acknowledge the helpful comments of colleagues at City University Business School, in particular Professor Richard Taffler, Dr Ayo Salami, Dr David Citron, Dr Mezziane Lasfer, Dylan Thomas, and Ash Mahate.

Also special thanks to the Chartered Association of Certified Accountants which partially funded this research and Sypas Limited for supplying the Z scores used in this research.

Finally, thanks to conference participants at Midwest Finance Association, March 1996, European Finance Association, August 1996, seminar participants at City University Business School, December 1995, The Management School, Lancaster University, April 1996, and London Business School, June 1996.

To my wife Carol

Declaration

I grant powers of discretion to the University Librarian to allow this thesis to be copied in whole or in part without further reference to me. This permission covers only single copies made for study purposes, subject to normal conditions of acknowledgement.

Abstract

In spite of decades of research into corporate turnaround strategies, corporate failures persist. Knowledge of remedies appears to be a necessary but insufficient condition for turnaround. There exists yet a serious gap in extant knowledge on what motivates managers to choose or avoid well-documented restructuring strategies. Further, extant research has focused predominantly on severely distressed firms. Though contributing immensely to corporate management out of a crisis, it throws little light in the direction of management to avoid a crisis, and thus avoidance of economic value destruction. Also, no large sample analysis has properly tested the general effectiveness of prescribed turnaround strategies.

This research attempts to fill these empirical gaps by exploring three key research questions:

1. What are the determinants of restructuring strategy choice in response to performance decline?
2. How effective are the prescribed turnaround strategies in contributing to corporate turnaround from performance decline?
3. Are the turnaround strategies equally applicable and effective to both poorly performing and financially distressed firms?

We integrate the disparate studies to date and devise a coherent framework for performance decline research and corporate restructuring. We also design a comprehensive strategy determinants framework for explaining the firm strategy selection process, incorporating the impact of lenders, owners, corporate governance structure and control factors. We employ the standard event study methodology to examine effectiveness of strategies. We then separate implementation success from other sources of strategy effectiveness - choice, timing and intensity of restructuring strategies. We also explore differences in the determinants and effectiveness of strategies between two samples comprising nearly 300 poorly performing and 200 financially distressed firms, as a function of the extent of firms' performance decline.

Our results show that turnaround strategy choices are significantly influenced by the complex interplay of the ownership structure, corporate governance and lender monitoring of the firms in decline. While there is agreement among stakeholders on certain strategies there is also evidence of conflict of interests. The results also show the somewhat detrimental effects of dominance by certain stakeholder groups. However, no support for managerial inaction as a contributor to non-recovery from performance decline is found. Instead of being paralysed by inertia, managers of non-recovery firms appear to take vigorous and intensive restructuring actions. Our results suggest the root cause of non-recovery is bad implementation of restructuring strategies. Although pursuing similar strategies, non-recovery firms' managers are perceived by the market to be far less effective in their implementations than those of recovery firms. Comparative analysis of poorly performing and financially distressed firms reveals a striking similarity in determinants of strategy choice but some differences in the impact of restructuring strategies on corporate turnaround.

Chapter 1. RESEARCH OBJECTIVES

1.1 Introduction

The research theme in turnaround or distress studies has shifted from decade to decade. The focus in the 1960's, was on accounting measures of firm performance and failure prediction models (e.g. Beaver, 1966, and Altman, 1968), in the 1970's on more sophisticated failure prediction models and turnaround strategies (e.g. Argenti, 1976, Schendel, Patton and Riggs, 1976), in the 1980's on more strategic management research (e.g. Hambrick and Schechter, 1984; Slatter, 1984) and some financial economics-based work (e.g. Gilson, 1989), and in the 1990s to specific study of corporate restructuring actions in response to financial distress (e.g. Gilson, 1990; Robbins and Pearce II, 1992; Ofek, 1993).

Although the literature prescribes a range of corporate restructuring strategies, few studies to date have explored comprehensively and empirically the determinants of corporate restructuring strategy choice. Although organisational resistance to deep cuts in costs and assets is noted by strategy researchers (Bibeault, 1982; Sloma 1985), and firms able to overcome such resistance are found to be better positioned to achieve a turnaround (Slatter, 1984), few strategy researchers have empirically explored the motivations and compulsions behind managers' restructuring strategy choices. The failure to appreciate why managers choose or avoid particular strategies may have contributed to the persistence of corporate failures, despite the voluminous turnaround research to date.

The choice of turnaround strategies is contingent upon a number of factors.

Firms' choice of turnaround strategies is primarily influenced by the firm's major stakeholders such as managers, shareholders and lenders. Since different strategies may have different, and often conflicting, welfare implications for managers, shareholders and lenders, the choice of any strategy can only be made as a trade off among these contending stakeholders. The restraints on any single stakeholder group such as managers maximising their own self-interest to the detriment of other stakeholders is a function of the governance structure and the mechanics of agency monitoring in a firm (Gilson, 1990). Thus, an understanding of the nature and sources of these restraints is necessary to make the appropriate turnaround strategy choices.

Most of the restructuring strategies prescribed in the turnaround literature are largely based on small samples or case-study-based analyses. The general applicability of these generic and specific strategies has not yet been tested on a large, multi-industry sample. Further, no large scale cross-sectional analysis has been conducted to test the general effectiveness of these turnaround strategies.

Corporates' downward spiral to failure is attributed by past researchers (e.g. Schendel et al., 1976; Hofer, 1980; Hambrick and Schechter, 1983, Hoffman, 1989, Weitzel and Jonsson, 1989; Barker and Mone, 1993) to managerial inaction, and poor timing, lack of intensity and poor implementation of turnaround strategies. Again, empirical evidence on the factors underlying the effectiveness of strategies, based on large scale analysis, is limited.

Moreover, extant studies in corporate turnarounds have invariably focused

on firms with severe distress - firms that have sunk into crisis after a number of years of declining performance. Though extant research in corporate turnarounds contributes significantly to successful management of crisis, it throws only scant light on how corporate management should act to avoid a crisis. Turnaround strategies are not relevant only to severely distressed firms. They are equally applicable to firms suffering from poor performance and to those aiming to achieve improved financial or competitive performance (Slatter, 1984). Poor performance firms do not wait to become severely distressed and destroy economic value along the way, before taking any action. Instead, management often seek to 'stop the bleeding' and nip the problem in the bud through restructuring. However, only a few studies have examined firms' actions in response to poor performance short of distress. Interesting but unanswered empirical questions remain: (1) Do poor performance firms recover or sink into severe distress? (2) Do firms that recover adopt restructuring strategies different from those that decline into severe distress, (3) What determines management's choice of restructuring strategies that may be instrumental in corporate recovery? and (4) How effective are these strategies in contributing to a turnaround from performance decline?

Ofek (1993), Robbins and Pearce II (1992) and Pant (1986) shift the focus away from predominantly severely distressed firms and investigate how firms respond to poor performance. However, these studies suffer from weak definitions of poor performance and use of incomplete strategy determinant models.

Ofek (1993) defines poor performance as a situation where a firm experiences a sharp decline in stock market returns ranking, i.e. it falls from the top 67% in one year to the bottom 10% in the subsequent year. Ofek's definition may incorporate firms lingering below average performance for many years prior to decline to bottom 10%. Robbins and Pearce II (1992) define a poor performance firm as one with two successive years of increasing ROI (return on investment) and ROS (return on sales) followed by an absolute decline in both ROI and ROS for a minimum of two years, the rate of decline exceeding the industry average rates. However, Robbins and Pearce II's definition is flawed as firms that have rising ROI and ROS for two years may still end up with returns ranking below industry average (bottom 50% rank), whilst firms that have declining ROI and ROS for two years may still have returns ranking above industry average (top 50% rank). Pant (1986) defines a poor performing firm as one that remains in the bottom 25% of firms in its industry, in terms of ROA, for a period of two years. However, Pant does not specify that a firm has to exhibit superior performance (i.e. be in top 50%) prior to reporting a drop to the 25% rank. This definition ignores the exact timing of decline and can include firms that may have underperformed their industry for a number of years prior to decline to the bottom 25% rank.

Ofek's (1993) study is the only research that empirically examines the determinants of firms' actions in response to poor performance. His results support Jensen's (1989) contention that high leverage and associated high lender

monitoring induce speedy firm actions to remedy poor performance. Greater going-concern value is therefore preserved by highly geared firms than by less geared firms. However, Ofek finds block shareholder monitoring to be insignificantly related to corporate actions, contrary to subsequent findings by Bethel and Liebeskind (1993).

Ofek's findings, and particularly the findings of past turnaround studies, need to be interpreted with caution as they do not apply a comprehensive strategy determinants framework. The comprehensive strategy determinants framework devised in this research includes firm specific factors such as lender monitoring, block shareholder influence, board structure, managerial shareholding, severity of decline, cause of decline, firm size, and external economic and industry conditions. The exclusion of board monitoring variables and the external environment in past studies may have resulted in potentially flawed results caused by omitted variables.

However, the conceptual strategy determinants framework we develop does not relate every agency or control variable to every restructuring strategy. To this extent some of the empirical work in this research is exploratory. In this respect, the thesis not only contributes UK evidence to confirm existing theories but also provides new empirical evidence to substantiate new concepts, such as the role of firms' governing board during the critical period of performance decline.

Although past turnaround researchers have examined the issue of what strategies are instrumental to corporate turnaround, they have not tested the

effectiveness of strategies on a proper basis. Past studies such as by Schendel and Patton (1976) and Robbins and Pearce II (1993) suffer from two fundamental methodological deficiencies. First, they confound proxies for strategies with the criteria for turnaround, for example cost reduction as a strategy and improvement in profit margin as a turnaround performance measure. Second, proxies for cost reduction strategies such as lower cost of sales, may be impacted by various other specific strategies such as operational restructuring, asset sales, investment in new plant and machinery or acquisition of new businesses, or financial restructuring which gives rise to lower interests cost. In other words, the accounting proxy often merely measures the end result of a strategy and not the strategy itself. Hence, the question, whether declining firms' chosen restructuring strategies are effective or not in accomplishing turnaround, remains largely unanswered.

1.2 Alternative perspectives on financial performance

In this study, we examine corporate responses to performance decline measured in two different ways: (1) The decline in relative stock returns performance and (2) The decline to financial distress, reflected in bankruptcy risk and measured by the conventional Z score. Whereas the first financial measure of performance decline is based on an explicit perspective of shareholder value maximisation, as a corporate objective, the second is an explicit measure of the potential bankruptcy risk. We believe that both perspectives are important in evaluating corporate responses to performance decline.

The conceptual premise of this study is that managers respond to performance decline reflected in both stock returns and accounting performance terms. However, managerial responses to the two types of decline may differ in terms of speed, scope and effectiveness. These responses may also differ in the factors which trigger or moderate them eg. Lender monitoring or share ownership structure. Arguably, bankruptcy risk, proxied by the Z score, represents a more stringent measure of performance decline, and is relevant to a much wider stakeholder community than stock returns.

1.3 Corporate restructuring framework

Consequent upon performance decline, management may respond by adopting various restructuring actions to regain the firm's financial health. This study employs a comprehensive corporate restructuring framework, synthesising both the strategic management and finance literatures. It covers the generic strategies of managerial, operational, asset and financial restructuring.

Managerial restructuring which entails the removal of top management responsible for the corporate decline is quoted widely as a prerequisite of corporate turnarounds. Restoring management credibility in the eyes of employees, lenders, and shareholders is so vital that replacing managers irrespective of their share of the blame for decline, may be seen as imperative.

One of the remedies most prescribed for poor performance is operational restructuring aimed at cutting costs, improving margins, productivity and profits.

Corporate managers wield the axe on costs via headcount reductions, overhead cuts, consolidation and termination of certain operational facilities.

Where operational restructuring is an inadequate remedy, due, for instance, to the existence of loss-making subsidiaries or where cash is required to fund restructuring, asset sales may be instigated.

Often, capital expenditure and acquisitions may be necessary to improve operational efficiency and productivity if the current state of operations is critically under-equipped due to past low investments or change in technologies. Also, once the operations are successfully rationalised and survival is assured, investments to rebuild and grow become a priority.

Frequently, a firm's finances are in need of surgery to resolve or avoid a financial distress. Financial distress is a situation where there is insufficient liquidity in the firm to meet current obligations. The commonest financial strategy then is to cut dividends drastically or omit them entirely. Next, negotiations may be initiated with lenders to rewrite covenants, where a breach is expected or has occurred, and refinance the firm on a committed and/or long term basis. Shareholders are also frequently asked to stump up more cash to keep the firm afloat by way of subscribing to fresh equity issues.

1.4 Determinants of restructuring strategy choice

The strategy and finance literatures abound in remedies for performance decline. Despite the proliferation of these remedies, corporate failures stubbornly

persist. Corporates' downward spiral to failure is widely claimed to stem from management inertia in the wake of performance decline. The question is 'Why do corporate managers fail to practise the 'wisdom' of past turnaround research?'

The answer may lie in the 'soft element' of corporate strategy - what determines managers' choice of strategy? The agency paradigm predicts managers can act in their own self interest. They may also act for the benefit of lenders to the detriment of shareholders, or vice-versa. However, managers do not have a free hand in choosing restructuring strategies, especially at moments of financial distress. Other key stakeholders such as lenders, owners and the governing board have their own motivation and preferences and hence influence the choice of strategy.

The role of corporate governance in the UK has undoubtedly been put in the limelight by the Cadbury Committee's report on corporate governance in December 1992 titled 'The Financial Aspects of Corporate Governance: The Code of Best Practice'. The report stresses the importance of division of power at the top so that no one person has unfettered powers of decision, and highlights the significant role played by non-executive directors¹. The impact of governance structure on restructuring strategies has not been recognised in most previous studies such as Ofek (1993). We plug this serious empirical gap by incorporating

¹Post-Cadbury, two other committees have been set up to further the work initiated by the 'Cadbury Committee'. The 'Greenbury Committee', set up in January 1995 and chaired by Sir Richard Greenbury, has examined and reported on good practice in determining and accounting for directors' remuneration. The successor to the 'Greenbury Committee' is the 'Hampel Committee', set up in 1996, to extend the Cadbury and Greenbury Committees' work.

board leadership and composition variables into our strategy determinants framework.

The choice of strategy is, therefore, ultimately, dependent on a complex interplay of power and influence among managers, lenders, owners and the governing board. Certain uncontroversial strategies may be adopted easily. Others, such as asset sales to raise cash to pay lenders, may benefit lenders at the expense of shareholders who lose the option value of the assets sold and, may, therefore, be resisted by the disadvantaged group. Potentially, the downward spiral to corporate failure may be driven by the selfish power plays of stakeholders.

1.5 Effectiveness of restructuring strategies and corporate turnarounds

Given that managers, under the influence of stakeholders, decide to adopt a range of strategies to combat financial performance decline, do they succeed in their endeavours, and manage to turn around their firms' declining performance? Is faithful adoption of the generic turnaround strategies a guarantee of a success?

As described earlier, past turnaround studies have applied flawed methodologies in their investigation of strategy effectiveness. A proper approach to examining strategy effectiveness should directly test the impact and effectiveness of specific strategies and avoid using proxies for effectiveness which may be affected by a range of strategies or factors. Since the long term effect of a specific strategy is inherently incapable of direct measurement, two appropriate approaches to measuring such effects are the event study and econometric

regression methodologies. Event study methodology can be used to capture the shareholder wealth effects of strategy announcements reflecting the perceived effectiveness of strategies, at least from the stock market perspective. The regression approach is based on testing the association between restructuring strategies and the extent of corporate recovery from performance decline. If a restructuring strategy is effective, it will register a strong positive association with recovery from performance decline.

We also contend that the choice of apparently appropriate strategy and the speed and intensity of its application are a necessary but inadequate condition for turnaround success. The key to successful turnaround lies in effective implementation. The best strategy is futile if implemented badly, indiscriminately or half heartedly. In this research, effective implementation is measured in terms of achieving a benchmark performance. This benchmark is defined later in Chapter 5.

1.6 Research objectives and contribution

We aim to fill the empirical gap by extending and improving on existing studies. The unique contributions of this study lie in a more comprehensive conceptual framework, in improved empirical methodology and in the examination of a wider range of issues relating to the choice and effectiveness of turnaround strategies than in the extant literature.

The key objective of this research is to examine empirically three related

research questions. First, what are the determinants of corporate restructuring strategies in response to performance decline? Second, how effective are the various corporate restructuring strategies in contributing to firm recovery from performance decline? Third, what are the differences, if any, in the determinants and effectiveness of restructuring strategies between merely poorly performing and financially distressed firms?

We apply a comprehensive strategy determinants framework, incorporating the agency perspective which is generally missing from decline-related research in finance as well as strategy literature. This framework integrates approaches in the strategic management literature with the finance-based agency theory widely researched by financial economists. An integrated strategy determinants framework enables managers seeking turnaround strategies to understand the complex forces impacting on strategy choice, gather support from various stakeholders, and enhance the effectiveness of chosen strategies. Managerial failure to take into account the complex interplay of influences may accentuate conflict of interests amongst contending stakeholders and thereby impede recovery.

In terms of methodology, we formulate a practical and simplified framework for performance decline research by integrating, and putting into perspective, the disparate studies of distress to date. The framework classifies sample firms by their severity of performance decline, i.e. non-distress and distress. The simplified framework is conceptually easier to understand and

operationalise for empirical analysis.

Also, instead of looking at restructuring strategies piecemeal, we formulate a comprehensive framework which integrates the 'gestalt' of turnaround strategies found in the strategic management literature and the corporate restructuring strategies examined in the financial economics literature. This framework encompasses managerial, operational, asset and financial restructuring. The comprehensive framework provides corporate managers with a range of strategic choices and the possibility of maximising recovery prospects through employing an integrated, rather than, a piecemeal approach to corporate turnaround.

In addition, we employ a longitudinal analysis of corporate restructuring strategies for three years from the year of performance decline. This significantly improves on Ofek's one year study of the determinants of strategy choice, and thus allows for a longer tracking of firm actions following the year of performance decline, leading to recovery or severe distress.

We also employ improved methodologies to test for the effectiveness of restructuring strategies. We use shareholder wealth effects of strategy announcements to proxy for perceived strategy effectiveness. These wealth effects are measured using standard event-study methodology. In addition, we apply econometric models to examine the impact of restructuring strategies on recovery from performance decline.

To ensure the robustness of our results, we choose to examine two samples of firms, rather than one. They are non-distressed but poorly performing firms, and

financially distressed firms. The aim is to compare and contrast the determinants and effectiveness of restructuring strategies for firms experiencing different degrees of performance decline. We can gain insights into the forces impacting on firms' strategy choices, the general applicability and relative effectiveness of restructuring strategies, for these two turnaround situations. The results would be of immense interest to corporate managers, lenders and investors alike.

1.7 Outline of thesis

Chapter 2 reviews the literature for alternative perspectives on financial performance measures, from performance decline to financial distress. The review highlights the attractiveness and criticisms of popular measures based on accounting returns, cash flows and stock returns. Based on synthesising extant studies a performance decline research framework is formulated. The choice of performance measures used in this study to define the poorly performing and financially distressed samples is discussed.

Chapter 3 reviews the finance and strategic management literature on restructuring or turnaround strategies. A comprehensive corporate restructuring framework encapsulating the four generic strategies identified in the literature is devised. The generic strategies are managerial, operational, asset and financial restructuring.

Chapter 4 reviews the literature on determinants of restructuring strategy choice. The existing evidence on the impact of firms' agency monitoring

mechanism and other internal and external factors on strategy choice are discussed. This exercise reveals a serious lack of evidence, particularly in the UK, on what determines firms' choice of restructuring strategy, in a turnaround context. Resulting from the review, an overall strategy determinants framework is designed representing the complex forces impacting on strategy choice, but which have been largely ignored in past studies.

In Chapter 5, we discuss the deficiencies of extant turnaround strategy effectiveness measures, propose improved methodologies and support them with evidence from a review of wealth effects of strategy announcements predominantly from the finance literature. The aftermath of decline and the factors contributing to corporate turnaround are also discussed.

Chapter 6 outlines the methodology for measuring poor performance and financial distress and the sampling criteria. The logistic regression equations used to investigate the impact of determinants of agency and control variables on restructuring strategy choice are discussed. Also, the methodology to assess the effectiveness of strategies is presented. The definitions of dependent and independent variables are presented and the characteristics of both poor performance and financial distress samples are described in the chapter.

Chapter 7 presents the results of stakeholder dominance and logistic regressions of restructuring strategies on agency and control variables for the poorly performing sample. The separate impact and joint impact of explanatory variables on restructuring strategy choice are identified and their economic

meaning is discussed.

Chapter 8 reports and discusses the empirical results on effectiveness of restructuring strategies for the poorly performing sample. The results from event study analysis, and logistic and ordinary least squares (OLS) regressions of corporate recovery from poor performance on restructuring strategies and control factors are discussed.

Chapter 9 reports and discusses the empirical results on the determinants and effectiveness of restructuring strategies for the financially distressed sample. Results of stakeholder dominance and logistic regressions of restructuring strategies on agency and control variables for the financially distressed sample are presented. The separate impact and joint impact of explanatory variables on restructuring strategy choice are identified and their economic meaning is discussed. The results from logistic and OLS regressions of corporate recovery from financial distress on restructuring strategies and control factors are also discussed.

Chapter 10 compares and contrasts the determinants and effectiveness of restructuring strategies between the poorly performing and financially distressed samples. Possible reasons for similarities and differences are explored.

Chapter 11 summarises the research outline, and the empirical findings. It also discusses the implications for corporate managers, lenders, owners and policy makers, and provides suggestions for future research.

Chapter 2. ALTERNATIVE PERSPECTIVES ON FINANCIAL PERFORMANCE DECLINE

2.1 Introduction

Despite the wealth of decline-related studies, no coherent framework integrating the disparate research conducted to date is yet established (Robbins and Pearce II, 1992, 1993). For example, there exist as many definitions of distress as there are empirical studies on the subject. In this chapter, we review the extant distress literature for different perspectives on financial performance measures, and explore several models of distress. Based on a synthesis of the extant studies, we formulate a more comprehensive performance decline research framework, and define the type of financial decline examined and choice of performance measures used in this research.

2.3 Financial performance measures

As the first stage in any turnaround study is to define what is meant by firm performance, in this section we explore in detail, the alternative measures of financial performance used in the literature.

Since Beaver's seminal paper in 1966 on accounting measures of corporate performance, there has been a profusion of research in distress-related areas with distress being defined on the basis of accounting performance measures. However, recently, several studies have used stock-returns as performance measures (e.g.

Gilson, 1989, 1990,1993; and Ofek, 1993). Unfortunately, a consensus definition is still elusive, and in fact there appear to be as many variations of definitions as there are research papers. Also, a significant number of recent studies employ debt/bankruptcy-based measures of distress, i.e. financial distress as evidenced by default and potential default on debt (e.g. Gilson and Vetsuypens, 1993). The following discussion is based on a review of decline-related studies from the 1960s to date. A summary of this review outlining the distress definitions used in past studies is included as Appendix 2.1 to this chapter.

2.3.1 Accounting-based performance measures

In a nutshell, the literature on accounting-based definitions can be broadly categorized into earnings, accounting return, cashflow and composite-accounting-based measures.

i. Earnings-based accounting performance measures

Many studies identify candidates for potential turnaround using the earnings level. Popular definitions of earnings are profit before tax and profit after tax or net income. Schendel, Patton and Riggs (1976), in one of the first major studies of corporate turnarounds, define a turnaround candidate firm (hereafter referred as turnaround firm) as one with four consecutive years of earnings decline. Similar definitions adopted by subsequent turnaround researchers are growth in net income less than industry average over three years (O'Neill, 1981), minimum three years of decline in net income or decline of 80% or more in

earnings in a single year (Bibeault, 1982), minimum three years of successive decline in real (net of inflation) pretax profit (Slatter, 1984), and at least one year of negative earnings following positive earnings (John, Lang & Netter, 1992).

Earnings level on its own is meaningless except when used for comparison purposes. Comparisons can be made over time to highlight significant improvement/deterioration in financial performance. Generally, the use of earnings level per se to measure firm performance can be flawed. Earnings level can be boosted for example by acquisitions which in turn increase capital or assets employed. However, the resulting return (say ratio of earnings to assets) may be relatively worse than in prior years. On the other hand, earnings level may not suffer from accounting asset changes e.g. asset write-offs to reserves, which tend to distort ratio-based measures, such as return on assets which has assets as its denominator (Ramanujam, 1984).

ii. Accounting return-based performance measures

Accounting returns are returns based on profits, at various levels e.g. profit before tax and profit after tax, deflated by either sales, assets/capital employed or shareholders' equity. Popular accounting return-based measures are therefore return on sales (ROS), return on asset or investment (ROA/ROI), and return on equity (ROE). Accounting return-based definitions of turnaround candidates in the extant literature include: average ROA below US Treasury Bond yield (Graham and Richards, 1979), average pretax return on investment (ROI) below

10% for two years (Hambrick and Schechter, 1983), four or more years' decline in ROI to below 5% (Ramanujam, 1984), ROA in bottom 25% of industry ranking for two years (Pant, 1986), negative post-tax return on sales (ROS) for a minimum of one year (Zimmerman, 1989), and successive increase in ROI and ROS for at least two years followed by absolute decline in both ROI and ROS for at least two years, the rate of decline greater than that of the industry average (Robbins and Pearce II, 1992).

As with level earnings, accounting ratios themselves are meaningless except when used for comparison purposes. Comparisons can be made over time to highlight significant improvement/deterioration in financial performance or compared to industry averages to detect under-over-performance relative to industry rivals. Past studies (e.g. Hambrick and Schechter, 1983) have predominantly focused on comparison over time although recent studies (e.g. Pant, 1986, and Robbins and Pearce II, 1992) have recognized the need to adopt both time and industry comparisons. Potentially, a decline in a firm's ratio over a period of time may simply mirror a decline in the entire industry, and the firm may be relatively no worse off than its competitors. However, being the best in a troubled industry may not necessarily mean the firm is financially healthy. Further, the extent of a decline, for example to the bottom 25% in the industry (Pant, 1986), better represents the within-industry variation of accounting returns. In other words, describing the firm's return as below industry average is insufficient as it does not indicate how far the firm's return is below its industry rivals.

However, caution should be taken when using accounting returns ratios. ROA measures how effectively management operate the business and how productively assets are employed. As ROA is a product of ROS (net profit margin) and asset turnover (profit before interest and tax/sales x sales/net assets), ROA is distorted by variations in net assets computation. In other words, varying depreciation policies or greater prudence in writing down assets, during the turnaround period to reflect permanent diminution in assets, affects ROA. On the other hand, ROS alone is insufficient to evaluate firm performance as firms operating in a low margin, high turnover business e.g. food retailing, may have robust profits due to the productive employment (or turnover) of firm assets. Next, ROE, as measured by net income over shareholders' equity, is also subject to variations in firms' capital structure and financial risk. In simple terms ROE² is a product - $\{[(ROA \times \text{Assets}) \text{ less interest}] \times (1 - \text{tax rate})\} / \text{equity}$. Firms can increase profits through increasing borrowing whilst simultaneously benefiting from the tax-deductibility of debt interest, a benefit not available from dividend payment to shareholders. In simple terms, ROE can be boosted by raising more debt capital, providing the ROA generated exceeds the costs of borrowing. However, as financial gearing increases, the probability and costs of bankruptcy also increase. Hence, in addition to the problems associated with ROA, ROE's comparative value is potentially undermined by variations in firms' financial

²Adapted from Shapiro's (1991, p755) modified Du Pont formula. Assets are equivalent to the sum of debt and equity funds. Extraordinary items are included within items forming profit before interest and tax, in accordance with Financial Reporting Standard FRS 3.

gearing and risk level.

Two ratios popularly tracked by analysts in the City are earnings per share (EPS) and the price-earnings (P/E) ratio. EPS is measured by the ratio of profit after tax, extraordinary item (since FRS3 became effective in 1993), minority interest and preference dividend to the average number of shares in the year. It indicates the earnings attributable to shareholders but is different from dividends insofar as the company's payout policy is not 100% or where dividends are maintained and paid out of past earnings despite negative current earnings. P/E ratio is measured by price per share over earnings per share (see e.g. Shapiro, 1991, p 757). If the stock market is efficient at least in the semi-efficient form, stock prices would reflect all publicly available information (Fama, 1970, 1991). Thus, changes in market prices signal market participants' assessment of corporate earnings and their likely impact on shareholder wealth. P/E ratio provides an indication of market's perception of firms' growth and profit opportunities as well as the risk attached to them.

Surprisingly, despite the City's keen focus on EPS and P/E ratios, extant research on turnaround has largely avoided them as measures of financial performance. Presumably, this may be born out of ignorance or due to an appreciation of the inherent weaknesses of the two measures. EPS may suffer from 'bootstrapping' effects i.e. artificial boosting of earnings, caused by acquisition of low P/E companies with high P/E shares. As P/E ratio is made up of market price per share over EPS, P/E ratio is open to potential distortions caused by stock

market anomalies such as 'overreaction' and size effects (see discussion below), on top of the deficiency inherent in its EPS denominator.

iii. Cashflow-based accounting performance measures

The term distress is widely taken to refer to financial distress. This is defined as a condition in which a firm has insufficient cash flow to cover current obligations (Wruck, 1990). Carrington and Aurelio (1976), in their study of a small US firm, define financial distress as one where a firm faces severe cash shortage. However, it is not easy to use cash flow to measure distress. For example, a firm with negative net cash position may not necessarily be in financial distress if it has unutilised debt capacity which allows it to increase its borrowing. Therefore, unless a firm's debt capacity is known, it is difficult to tell if the cash shortage is critical to the firm's survival. Presumably, due to the technical difficulty in operationalising cash shortage, no other empirical turnaround study has attempted to explicitly define distress based on cash flow.

iv. Multivariate accounting performance measures

ROA and ROE are univariate measures. A widely recognised multivariate measure is the Z score. Altman (1968) created the Z score as a measure of firms' bankruptcy likelihood. In the UK, a popular Z score model used by banks and

industrial firms has been developed by Taffler (1976,1984)³. Using the multiple discriminant analysis technique, a composite Z score integrating multiple financial ratios is developed to distinguish failing from non-failing firms. A composite Z score is technically superior to individual ratios as it captures a much wider perspective of financial performance with its multi-factor nature. However, Z scores may suffer from cut off problems i.e. below what score is a firm potentially bankrupt and above what score is it financially healthy, and the lack of a conceptual underpinning to the statistically chosen ratios (see e.g. Gambling, 1985).

2.3.2 Debt/bankruptcy-based performance measures

A popular proxy employed in recent studies to capture cash crisis or financial distress is the incidence of debt restructuring, both private and public restructuring (under the auspices of Chapter 10 or 11 of the Bankruptcy Code in the US and the Insolvency Act 1986 in the UK). Empirical studies employing this definition include Gilson (1989, 1990, 1993), Brown et al. (1993, 1994) and

³There is voluminous work in corporate failure prediction in the literature. Differences among these failure prediction models tend to lie in their explanatory variables. They range from models employing: key financial ratios (eg. Altman, 1968 and Taffler, 1974); cash flow data (eg. Aziz and Lawson (1989) and Gahlon and Vigeland (1988)); stock market variables (eg. Scott, 1981); and non-financial information such as lag (delay) and changes in lag in filing of annual accounts, changes in directors shareholdings, and director resignations (Peel, Peel and Pope, 1985). Also, extant studies employ statistical methods ranging from univariate (Beaver, 1966) to multivariate discriminant analysis (eg. Altman, 1968), conditional probability models (eg. Gentry et al, 1985; Peel, Peel and Pope, 1985), non-parametric analysis (eg. Barniv and Raveh, 1989, recursive partitioning (eg. Frydman et al, 1985), and neural networks techniques which circumvent many of the problems inherent in parametric analysis (eg. Coats and Fant, 1993).

Franks and Tourous (1994). To avoid capturing firms that restructure their debt voluntarily, without the pressure of financial distress, these studies impose additional conditions in their distress definitions. Gilson (1989, 1990, 1993) restricts his sample to firms which have suffered a severe decline in stock market performance i.e. drop to the bottom 5% in three years' cumulative returns in the market. Similarly, Brown et al. (1993) look for evidence of distress in news reports of firms restructuring their debt, while Franks and Tourous (1994) impose a debt downgrading to CCC or worse grade (ie. speculative investment grade) in firms that restructure their debts.

The incidence of debt restructuring is not suitable as a criterion for capturing firm performance decline for two reasons. One, since only highly geared firms tend to require a debt restructuring, lowly geared firms which tend not to restructure their debt may be defined as not experiencing performance decline. Two, although high gearing is observed to be a cause of decline (Slatter, 1984; John, Lang and Netter, 1992), it may not necessarily be the key factor driving performance decline. The major reason we do not define performance decline in terms of debt restructuring is that we regard such restructuring as a turnaround strategy. Thus, debt restructuring in our framework is a consequence, rather than a cause, of performance decline.

2.3.3 Stock returns-based performance measures

In spite of the popularity of earnings-based definitions of distress in past

turnaround studies, several recent studies have used stock returns-based measures as a performance indicator. Since a firm's corporate objective is often posited as the maximisation of shareholder value, stock return as a measure of financial performance satisfies the objective of this key stakeholder group.

Ofek (1993) defines a poor performance firm as one with its annual stock return ranking in the bottom 10% of all firm returns in the stock market after having been in the top 67% the year before. Each firm in his sample has a minimum drop of 23% and a maximum drop of 100% in ranking. Gilson (1989) defines distress as a situation in which a firm falls to the bottom 5% ranked on three years' cumulative returns in the market and the firm either defaults, becomes bankrupt or restructures its debt in the surrounding five years⁴.

Extant empirical studies find that stock returns tend to lead earnings changes because historical financial reports are not designed to reflect expectations of future net cash flows on a timely basis. Put differently, stock returns reflect the revision in the market's expectation of future earnings (e.g. Kothari and Sloan (1992), Kothari (1992), Beaver, Lambert and Ryan (1987), Collins, Kothari and Rayburn (1987), Beaver, Lambert and Morse (1980), Benston (1976 and 1966), Ball and Brown (1968), Muth (1961)). In fact, several studies find prices to be better than past and current earnings in forecasting future earnings (e.g. Beaver, Lambert and Morse (1980), Collins, Kothari and Rayburn (1987)).

⁴As debt restructuring may be undertaken in response to an anticipated or actual default, a five year period surrounding decline is thus imposed by Gilson.

Similarly, earnings are also found by the above studies to be only one of many factors influencing stock returns changes.

However, stock prices and hence returns are influenced not just by fundamentals but also by supply and demand factors and market sentiments. Stock market-based measures are efficient only insofar as the market is 'rational' and efficient. Potentially, market sentiment can cause stock returns-based measures to erroneously characterise firms as experiencing performance decline even though the firm remains fundamentally and financially sound. More serious threats to stock returns and accounting earnings as performance measures are discussed below.

2.3.4 Criticism of stock return measures

A major criticism of stock returns as a performance measure is that stock returns are 'noisy' and are subject to market inefficiencies or anomalies. De Bondt and Thaler (1985, 1987) argue that mean reversion⁵ (see Poterba and Summers, 1988) in stock prices is evidence of stock market overreaction. They demonstrate the 'overreaction' anomaly by constructing arbitrage portfolios of long positions in 'losers' and short positions in 'winners' which yield an impressive average market-adjusted return of 31.9% over 10 consecutive 5-year test periods. Losers and winners are respectively the 50 worst performing and best performing stocks,

⁵ Mean reversion refers to the phenomenon of a variable's propensity to revert to its mean value in the long run.

measured on the basis of five years cumulative market-adjusted returns. De Bondt and Thaler attribute this to the tendency of investors to overweight recent information and underweight old information, as suggested by Kahneman and Tversky (1973). Investors expect 'losers' ('winners') to continue their recent poor (good) performance into the future. This results in the temporary overshooting of the equilibrium value of the affected firms' share prices. Such a strategy, based on going against investors' 'herd instinct', is generally referred to as a contrarian investment strategy.

The overreaction hypothesis has since been subjected to widespread investigation. As suggested by Power and Lonie (1993), the anomaly can be separated into studies of short- and long-run overreaction. Evidence in support of and against both types of the overreaction anomaly is mixed.

Evidence in support of the short-run overreaction hypothesis has been reported in studies over time periods ranging from a day (Dyl and Maxfield, 1987), a week (Howe, 1986 and Lehman, 1990), to a month (Zarowin, 1988, 1989). On the other hand, Atkins and Dyl (1990) question whether investors can extract profit from such a contrarian strategy once transaction costs are included. Also, in the UK, MacDonald and Power (1993) do not find a mean-reverting behaviour in short-horizon share returns. In other words, short run stock market overreaction, proxied by mean reversion in share returns as asserted by De Bondt and Thaler (1985), does not exist in the UK. A study by Jacobs and Levy (1989) finds only an asymmetric short-term effect. They find a significant

correction of the initial reaction to negative events e.g. report of losses, within one month but prices subsequently follow the general (i.e. negative) trend of the original event. Positive events e.g. report of positive NPV projects, on the other hand, do not exhibit any price reversals. This phenomenon is confirmed by Brown, Harlow and Tinic (1990) and Pettengill and Jordan (1990). However, these studies find a large proportion of the abnormal returns to be related to firm size and to arise in the month of January.

The debate on the long-run overreaction phenomenon is more extensive than on the short-run phenomenon. Apart from De Bondt and Thaler (1985, 1987), Poterba and Summers (1988) and Chopra et al. (1992) in the US, and Power, Lonie and Lonie (1991), and MacDonald and Power (1991) in the UK, find further evidence in support of the long run (over one year) overreaction anomaly. However, there are three popular alternative explanations to the overreaction phenomenon, both short and long run. Firstly, the size and seasonality effects are able to explain a major part of the phenomenon in studies for example by Keim and Stambaugh (1986), Zarowin (1989) and Campbell and Limmack (1993). Secondly, increase in risk and hence returns have been propounded by Chan (1988) and Ball and Kothari (1989) as explanation for abnormal returns found in 'overreaction' studies. However, DeBondt and Thaler (1987) also show that size and risk do not fully explain the abnormal returns found in their 1985 study, but

the January effect⁶ does apparently account for a substantial part of the excess returns found. Their conclusion is supported by the findings of Chopra et al.(1992). Thirdly, the conflicting findings to date can be traced to subtle differences in methodology, for example, in measurement of price and risk (Conrad and Kaul, 1993).

Mean reversion in accounting profitability measures is also found in studies by Jones, Tweedie and Whittington (1976), Mueller (1977), Clayman (1987) and Power, Lonie and Lonie (1991). In fact, mean reversion in accounting profitability tends to mirror share price reversals as seen in studies by De Bondt and Thaler (1987) and Zarowin (1989). The debate on mean-reversion behaviour is therefore not restricted to share prices. Indeed, DeBondt and Thaler (1985, 1987) argue that investors overreact to earnings announcements. They find earnings of losing firms (firms which have suffered an extreme decline in stock returns) to have fallen over the portfolio formation period but rebound strongly subsequently. They speculate that the market may overact to current earnings and not anticipate reversals in earnings. This, they argue, drives the stock prices of under-performing firms to too low a level, and over performing firms to too high a level. Similarly, Ettredge and Fuller (1991) find the existence of a one year overreaction (11.6% positive abnormal return) to negative earnings even after controlling for risk and size. However, their findings are criticized by Ali and Klein (1994) for bias in their

⁶This refers to the anomaly in stock returns where there exists a general tendency for large positive returns in the month of January.

abnormal return measure. Ali and Klein show that standard event study methodology which uses prior periods' returns to estimate the parameters of the market model introduces a measurement bias that favours finding positive abnormal returns following negative earnings announcements.

However, De Bondt and Thaler's (1987) and Zarowin's (1989) finding of an overreaction to earnings announcement is contrary to two sets of research studies which indicate an under-reaction rather than overreaction to earnings announcement i.e. post-earnings announcement drifts⁷ and security analysts forecast. First, studies on post-earnings announcement drift indicate that stock prices underreact to earnings (e.g. Ball and Brown, 1968; and Bernard and Thomas, 1989,1990). In respect of analysts forecasts, Klein (1990) finds them to be too optimistic in the case of prior 'losers' i.e. loss-making firms, which she argues to be consistent with underreaction rather than overreaction to earnings announcements. Similarly, Abarbanell and Bernard (1992) and O'Hanlon and Whiddett (1991) also find analysts' forecasts underreact to recent earnings. On the other hand, De Bondt and Thaler (1990) find security analysts make extreme and optimistic forecasts which they argue to be consistent with generalised overreaction.

⁷A phenomenon whereby the stock market does not respond completely and immediately to information contained in announced earnings (e.g. Bernard and Thomas, 1989).

2.4 Financial decline models

Financial distress is, arguably, not a dichotomous event but a continuum in which firms sink from a position of good financial health to a distressed one, gradually rather than abruptly. The literature contains several financial models which attempt to capture this decline process, and map the stages of decline from good financial health to extreme financial distress.

Lau (1987) proposes a five-state financial distress model to capture the continuum of financial distress. Her model deviates from conventional failure prediction models in that, instead of classifying firms as failing or non-failing, she estimates the probabilities of a firm entering one of five financial states. The continuum of corporate financial health comprises: 1. financial stability, 2. omitting or reducing dividend payment, 3. technical default or default on loan payments, 4. protection under Chapter 10 or 11 (in the US) and 5. bankruptcy and liquidation.

Lau's use of dividend cut/omission as a second stage of distress is potentially flawed. Firms can technically and do in practice continue paying dividends, financed perhaps by increased borrowings, in spite of severe losses and negative operating cash flows. Research on dividend policies such as by Marsh (1992) and Christie (1994) show firms to cut/omit dividends only as a final resort. Also, cut/omission in dividends may be driven by the need to conserve cash to fund growth opportunities (DeAngelo and DeAngelo, 1990). Lau's framework

may thus not capture the precise continuum of firm's financial health.

Weitzel and Jonson (1989) also develop an organisational decline model which documents the stages of decline as: 1. blinded, when the organisation is blind to the early stages of decline; 2. inaction when it recognises the need for change but takes no action; 3. faulty action when it takes, but inappropriate, action; 4. crisis when it reaches a point of crisis; 5. dissolution when it is forced to dissolve. Weitzel and Jonson's model captures the organisational behaviour of a corporate's downward spiral to failure. However, there exists tremendous difficulty in operationalising at least the first two stages of their decline model.

Winn (1993) synthesises the performance measures applied in bankruptcy studies and classifies them into five distinct categories of performance: 1. pre-bankruptcy (crisis); 2. declining profitability (and eventually cash flow); 3. substandard performance relative to industry; 4. declining market share; 5. inadequate asset productivity. However, Winn's classification does not reflect a continuum of distress. There appears to be a lot of overlap between the performance categories in her model.

The above review suggests that a practical performance decline framework must be capable of capturing the continuum of distress with minimal overlapping states while amenable to being operationalised.

2.5 Performance decline research framework

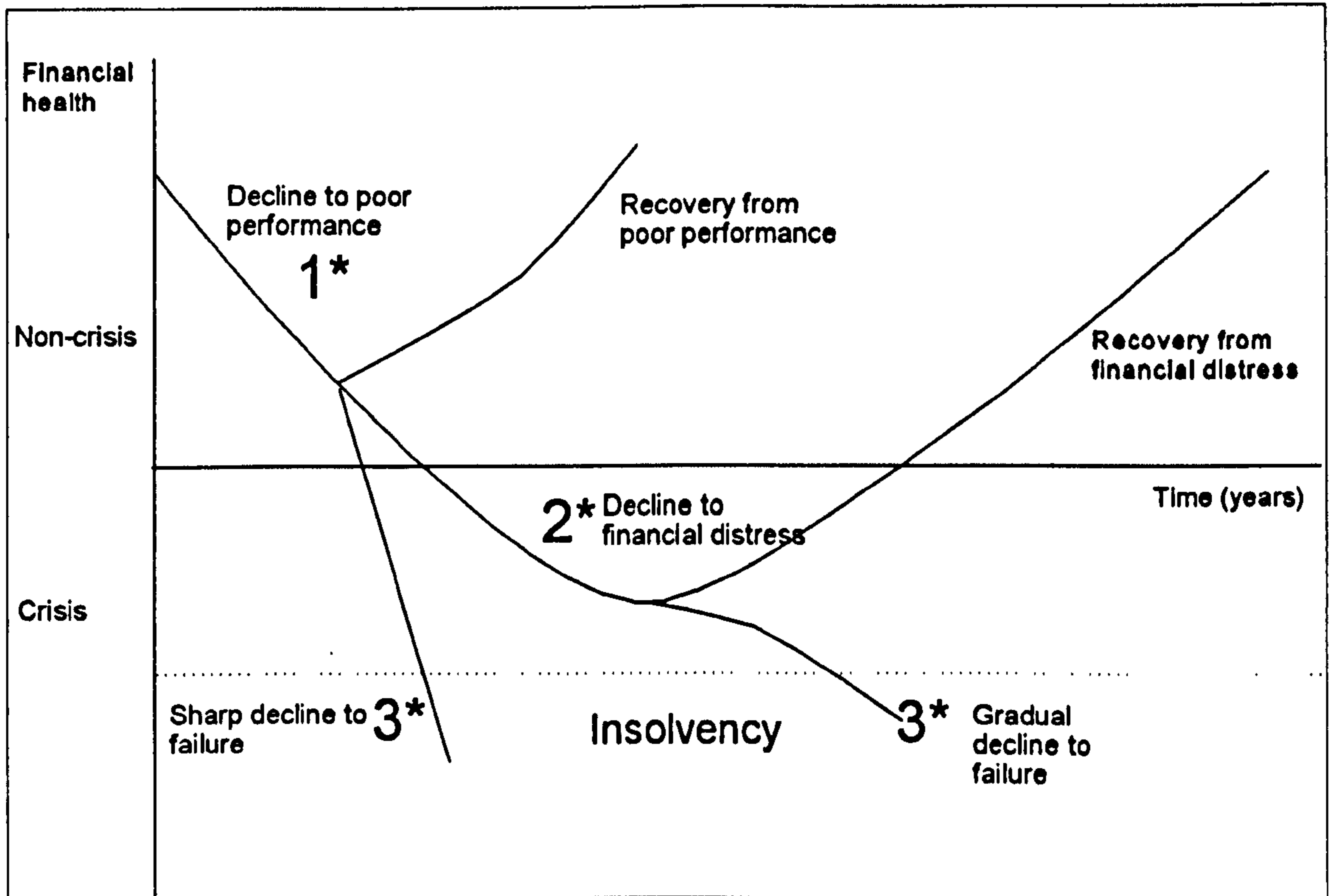
In the absence of a universally agreed definition of firm distress we synthesise the extant decline-related studies and define three categories of decline⁸ representing different degrees of financial decline: 1. non-crisis but poor performance (e.g. Robbins and Pearce II, 1992; Ofek, 1993), 2. crisis or (financial) distress⁹ (potential bankruptcy) (e.g. Hamermesh, 1977; Bibeault, 1982; Slatter, 1984; Zimmerman, 1989; Gilson, 1989; Brown et al, 1993), and 3. bankruptcy (e.g. Gertner and Scharfstein, 1991; Franks and Tourous, 1989). The term distress, in practice, tends to be applied generically to describe all the three categories. Figure 2.1 show the three categories of decline. The difference between the categories lies in the level of performance decline.

Poor performance firms (position 1*, Figure 2.1) are those which, after a period of superior performance, suffer a decline in performance. Superior performance is often taken as being among the top 50% of firms in the same industry, on accounting-based performance measures such as return on assets (ROA) (see for example Grinyer et al, 1988; Robbins and Pearce II, 1992) whilst poor performance is taken as being among the bottom 25% (Pant, 1986).

⁸ This classification is consistent with Hambrick and D'Aveni's (1988) description of corporate failure as a 'protracted process of decline' and a 'downward spiral'.

⁹Distress will be used throughout this research to refer to financial distress, unless where reference is made to studies employing the specific term financial distress.

Figure 2.1: Types of financial decline



Note: 1* = Poor performance; 2* = Distress (potential bankruptcy); 3* = Failure (bankruptcy)

According to Schendel et al. (1976) the time span for assessing firm performance should be long enough to ensure that any downturn is indeed due to some basic problem with the firm. A one year decline may not be long enough, for example, to rule out temporary demand shifts, introduction of new product or technology, and accounting rule changes (Winn, 1993). Therefore a minimum of two years' decline is often considered necessary to determine accounting-based performance decline (Robbins and Pearce II, 1992; Pant, 1986). In contrast, stock return performance-based measures may not suffer from this restriction. As the price of a firm's stock represents the present value of its future cash-flows and not

just one year's earnings or cashflow, a sharp decline in one year stock performance may be sufficiently indicative of long term poor performance.

However, the literature on stock price overreaction (De Bondt and Thaler, 1985) raises the concern that a stock return-based measure of performance decline may merely represent a correction for the earlier overreaction. This problem can be mitigated by incorporating the condition of two consecutive years' good performance preceding decline. Further, anecdotal evidence suggests that stock market performance decline is not greeted with inertia and indifference by managers who smugly attribute such decline to the stock market whims such as overreaction. It appears that such performance decline is a cause for managerial concern and triggers remedial action including corporate restructuring (Barker, 1996)..

In the wake of poor performance, management may take no action, a classic cause of failure (see Schendel et al, 1976; Bibeault, 1982) or adopt various corporate restructuring strategies which may, or may not, be appropriate to recovery from poor performance. In consequence, poor performance firms can recover from their poor performance, decline gradually to distress (position 2*) or decline precipitously into failure or bankruptcy (position 3*).

Distressed firms are, therefore, poor performance firms that have consistently declined for two or more consecutive years culminating in a financial crisis. Distress therefore manifests itself in profit and/or cash flow crisis. Cash flow crisis is a situation where a firm suffers from an acute cash flow problem

with insufficient cash to meet its financial obligations. As a result of management action or inaction, distressed firms may recover or decline to bankruptcy. Poor performance firms can potentially slide rapidly into bankruptcy without passing through a prolonged period of performance decline. Equally, a firm can slide directly into distress without being initially poor performing due for example to fraud e.g. BCCI and Polly Peck.

Financial distress firms are generally defined (e.g. Gilson et al., 1990; Wruck, 1990) as firms that have insufficient cash flows to cover current debt obligations. This tends to be evidenced by very low interest cover or liquidity ratios (Winn, 1993), default or restructuring of debt (Gilson et al, 1990), and negative Z score proxying for high potential bankruptcy risk (Taffler, 1984; Lasfer, Sudarsanam and Taffler, 1996). The mismatch between liquid funds and the obligations faced by firms in 'financial distress' can be alleviated by recontracting hard claims into soft claims (debt restructuring) or converting illiquid assets into liquid assets (asset restructuring) (John, 1993).

Failure to resolve distress will lead to position 3* of the distress continuum i.e. bankruptcy or insolvency. This is a situation when firms file for bankruptcy protection, in the United States, or when insolvency proceedings, such as administration, receivership or administrative receivership, are initiated in the United Kingdom. Details of UK insolvency procedures are included as Appendix 2.2 to this Chapter.

Finally, though not indicated in Figure 2.1, firms facing poor performance

can be taken over¹⁰. This aspect of performance decline research has received scant attention in the literature¹¹. However, our research does not focus on distressed firm takeover as a turnaround strategy¹².

2.6 Choice of decline and financial performance measures

We choose to investigate the first two stages of financial decline in our research framework i.e. firms experiencing poor performance, and firms experiencing distress as proxied by potential bankruptcy. As outlined in the research objective, this research aims to plug the gap in extant research with regard to the determinants and effectiveness of restructuring strategies in response to performance decline. As our research framework clearly illustrates, performance decline is not a static but a continuous event. As such, for a complete and thorough analysis of the determinants and effectiveness of restructuring strategies, we feel an examination of the entire spectrum of performance decline is imperative to

¹⁰Stallworthy and Kharbanda (1988) suggest that a declining firm may consider being taken over as a sensible 'survival' strategy. Distressed firms tend to have substantial accumulated tax losses. These tax losses are valuable to more profitable bidders as they could offset these losses against future profits. A recent example of a takeover where value of tax losses form a substantial element of 'financial synergy' is GKN's bid for Westland. Also, distressed firms may merge with equally or less distressed competitors in order to achieve economies of scale and consolidate their position in a crowded market. The high incidence of bank mergers in the US in the late 1980s lends support to this strategy (de Carmoy, 1990).

¹¹A recent study related to this area is by Clark and Ofek (1995) on post-takeover performance of acquired poor performance firms.

¹²Distressed firms may also be taken private or acquired. In this case distress may continue but the turnaround and turnaround strategies cannot be tracked. Hence, we do not focus on such firms.

ensure robustness of our results. However, the bankruptcy stage (stage 3) is not examined as UK firms rarely emerge from insolvency proceedings intact. They are frequently either sold piecemeal or as a going concern or closed down.

Given our choice of poor performance and distressed firms for investigation, what then are the appropriate financial performance measures to use to capture poor performance and distress? From Section 2.3, two financial performance measures emerge as the most suitable choice. They are stock returns and the composite accounting ratio, in the form of Z scores. These two measures reflect the different perspectives on financial performance decline from the view of the major stakeholders in a firm. Firms' major stakeholders, amongst others, are lenders, and shareholders.

Stock return as a financial measure of performance decline is based on an explicit perspective of shareholder value maximisation as a corporate objective, whilst Z score is an explicit measure of firm's potential bankruptcy risk. Stock return measures the degree to which shareholder objective of maximising returns on investment is met. On the other hand, Z score, proxying for potential bankruptcy risk, serves the objective of lenders well, as lenders are more concerned about risk of default than about levels of firm growth and return to shareholders' equity. Bankruptcy risk, proxied by Z score, arguably, represents a more stringent measure of performance decline, and addresses the concerns and interests of a more diverse stakeholder community than stock returns.

We believe that both perspectives are important in evaluating corporate

responses to performance decline. The conceptual premise of this research is that managers respond to performance decline in both stock returns and accounting performance terms, proxied by the Z score.

2.7 Corporate responses to performance decline

In response to performance decline, managers can sit back, do nothing and await recovery from say, a revival in industry and/or economic condition. Alternatively, they may adopt a range of restructuring strategies to restore their firms' financial health. We believe the latter is the more plausible scenario unless managers consider performance decline to be a process subject to 'auto-reverse'. The strategies espoused in the extant literature can be formulated into one comprehensive framework encompassing the strategies of managerial, operational, asset and financial restructuring. In the following chapter, we explore in depth the generic and specific strategies encapsulated in the corporate restructuring framework.

2.8 Summary

In this chapter, we have reviewed the literature for alternative perspectives of financial performance decline, formulated a performance decline research framework, specified the type of financial decline firms to examine, and chosen the appropriate performance measures to define them.

In the following chapter, we review the strategic management and finance literatures for turnaround and restructuring strategies.

Appendix 2.1: Review of decline-related studies: Definitions of Distress

Study	Distress definition and sample	US/UK
Accounting performance-based		
Altman (1968)	Z score model to predict corporate bankruptcy. 33 failed and 33 non-failed manufacturing firms in the period 1946-1965.	US
Argenti (1976)	Collapse is when a company, which has hitherto being operating successfully, just begin to falter and then has to fight to remain profitable. No empirical analysis.	UK
Carrington and Aurelio (1976)	Severe cash shortage. 1 small firm (case study) covering the period 1973-75.	US
Hamermesh (1976,77)	Profit crisis - where profit declines over prior years. 4 divisions of a US manufacturing firm, 1962-75.	US
Schendel, Patton and Riggs (1976)	Four consecutive years of decline in net income normalised by Gross National Product (GDP) growth. 54 manufacturing firms covering the period 1952-1971.	US

Appendix 2.1: Review of decline-related studies: Definitions of Distress**(Contd.)**

Study	Distress definition and sample	US/UK
Schendel and Patton (1976)	Firms' net income growth is lower than GNP growth for four years. 54 US manufacturing firms in the period 1952-71.	US
Taffler (1976)	Z score model computed using stepwise Linear Discriminant Analysis. 45 healthy and 23 bankrupt firms (mainly manufacturing firms), period 1968-1973.	UK
Graham and Richards (1979)	Average ROA less than average US Treasury Bond yields. 10 US railroads, 1957-1976.	US
Hofer (1980)	Operating health (firm value greater than liquidation. value) near breakeven. 10 firms over the period 1951-1978.	US
O'Neill (1981)	Growth in Net Income (NI) less than the industry average over 3 years. 51 US banks between 1959-78.	US
Bibeault (1982)	One or more years of losses or a severe decline of 80% or more of pre-tax profits in a single year. 81 mature US firms. 1967-76.	US

Appendix 2.1: Review of decline-related studies: Definitions of Distress

(Contd.)

Study	Distress definition and sample	US/UK
Hambrick and Schechter (1983)	Average ROI less than 10% for 2 years. 260 US manufacturing firms.	US
Ramanujam (1984)	4 or more years' decline in ROI (to below 5%). 64 US manufacturing firms, 1962-79.	US
Slatter (1984)	Real (1970 prices) profit before tax has declined for three or more successive years. 20% of the approximately 2100 quoted firms for part or all of the period 1961-76 were classified as in need of a turnaround. i.e. 437 firms. [Case analysis of 17 firms]	UK
Taffler (1984)	Z score model for distribution companies. 49 healthy and 24 failed firms, period 1974- 1978.	UK
Kharbanda and Stallworthy (1985)	Z score (supplied by Syspas Limited - Taffler, 1976, 1984) for failure prediction used in a few illustrations. No empirical work.	UK
O'Neill (1986)	Growth in net income less than industry average over three years. 13 US firms in the 1970s.	US

Appendix 2.1: Review of decline-related studies: Definitions of Distress

(Contd.)

Study	Distress definition and sample	US/UK
Pant (1986)	ROA in bottom 25% ranking of firm's industry for 2 years. 137 US industrial firms, 1970-83.	US
Grinyer, Mayes and Mckiernan.(1988)	A period of decline followed by an UK improvement in performance in the second period relative to decline period. The shortest time for the two periods together is three years. The focus is on companies which chose to and not forced to change by crisis. ROE, ROA, labour productivity (value added per employee) and capital productivity(value added per capital employed). 25 UK (mainly Scottish) firms in the period 1970 -79.	UK
Bonnier and Bruner (1989)	Negative earnings in the last quarterly report, accompanied by dividend omission no more than 2 years prior to decline. The firm must have paid at least four successive dividends before the omission. 70 firms, from 1969-1983.	US

Appendix 2.1: Review of decline-related studies: Definitions of Distress

(Contd.)

Study	Distress definition and sample	US/UK
Zimmerman (1989)	Negative net profit (after tax) as a percentage of revenue for one or more consecutive years. Case study on turnaround of 15 firms over 15 years.	US
Wruck (1990)	A situation where cash flow is insufficient to cover current obligations. No empirical work - a literature survey.	US
DeAngelo and DeAngelo (1990), and DeAngelo and DeAngelo and Skinner (1992)	Initially healthy i.e. one year of positive net income and dividend-paying followed by at least three years of negative net income (NI) or negative pre-tax operating income. Final sample - 76 dividend-reducing NYSE firms selected in the period 1980-85.	US

Appendix 2.1: Review of decline-related studies: Definitions of Distress

(Contd.)

Study	Distress definition and sample	US/UK
Robbins and Pearce II (1992)	Two successive years of increasing ROI and ROS followed by decline in both ROI and ROS for at least 2 years. The decline rate must also be greater than the industry average decline rate. 38 firms in the textile sector, between 1976-1985.'	US
John, Lang and Netter (1992)	At least one year of negative earnings, followed by three years of positive earnings. Questionnaire survey: Initial sample consists of 82 firms between 1980-87 with average annual assets of a \$1 billion or more. Final sample consists 46 firms after excluding firms taken over, gone private or filed for Chapter 11.	US
Lang, Poulsen and Stulz.(1995)	Firms which made voluntary asset sales (not in financial distress) in excess of \$1 million. 93 firms with asset sales from 1985-1988.	US

Appendix 2.1: Review of decline-related studies: Definitions of Distress

(Contd.)

Study	Distress definition and sample	US/UK
Lasfer, Sudarsanam and Taffler.(1996)	Z score (supplied by Syspas Limited - based on Taffler, 1976, 1984). Industry model (1976): 23 failed and 45 non-failed manufacturing firms, 1968-73. Distribution model (1984): 24 failed and 49 non-failed firms, 1974-78.	UK
Stock-return based Gilson (1989)	Ranked in the bottom 5% in the market on three year cumulative stock return. Financial distress is a situation where a firm defaults, goes bankrupt or restructures its debt in the surrounding 5 years of decline to bottom 5% ranking in the market based on three year cumulative return. 381 firms between 1979 and 1984.	US

Appendix 2.1: Review of decline-related studies: Definitions of Distress

(Contd.)

Study	Distress definition and sample	US/UK
Gilson, John and Lang.(1990)	Ranked in the bottom 5% in the market on three year cumulative stock return. Financial distress is a situation where a firm defaults, goes bankrupt or restructures its debt in the surrounding 5 years of decline to bottom 5% ranking in the market based on three year cumulative return. 447 firms. Period 1979-1985.	US
Ofek (1993)	Decline in stock returns ranking from top 67% in the market (base year) to bottom 10% (distress year) 358 firms with market value of \$30M or over. Period: 1983-1987	US
Debt/bankruptcy-based		
Franks and Tourous (1989)	Filing for Chapter 11 bankruptcy protection. 30 firms which emerged from Chapter 11, period 1970-1984.	US
Gertner and Scharfstein (1991)	Filing for Chapter 11 bankruptcy protection. Theoretical paper.	US
Brown, James and Mooradian (1993)	Firms restructuring their debt in private or through exchange offers. 63 firms.	US

Appendix 2.1: Review of decline-related studies: Definitions of Distress

(Contd.)

Study	Distress definition and sample	US/UK
Gilson and Vetsuypens (1993)	Same as Gilson (1989, 1990) Firms that either filed for bankruptcy or privately restructured their debts. 77 firms during the period 1981-1987.	US
Brown et al.(1994)	Default or anticipated default, near bankruptcy or restructuring of debt (as cause for asset sales). 49 firms in the period 1979-1988.	US
Franks and Tourous (1994)	Firms with publicly traded debt downgraded to Standard & Poor's CCC (repayment doubtful) or worse rating (including default (D) and non-rated (NR)) and which restructured their debt privately or publicly. 82 firms. Period 1983-1988.	US
Undefined		
Argenti (1976)	None.	UK
Melin (1985)	Not defined. Scandinavian TV manufacturers, 1970-1980, 6 firms.	N/A

Appendix 2.2: UK Insolvency Procedures

A2.2.1 Definition of insolvency

A company is insolvent if its liabilities exceed its assets i.e. it has negative shareholders funds (Insolvency Act 1986, S123 (2)), or where it is unable to pay its debts when they fall due (Insolvency Act 1986, S123(1)). A company is deemed to be 'asset insolvent' if the court is satisfied with evidence that the company's assets are less than its liabilities including contingent and prospective liabilities.

To return to asset solvency a company merely has to increase shareholders fund until it becomes positive again. Commonly, this can be achieved by way of share issues, asset revaluations, profits or a formal reconstruction to reduce liabilities.

On the other hand, inability to meet debts when they fall due can only be alleviated by the injection of cash via equity or borrowing, by the replacement of short-term borrowing with longer-term borrowing, or by a repayment moratorium. Also, a corporate reconstruction would enable a proposal to be put forward to creditors incorporating liquidity elements such as the deferment of repayment of term loans, interest holidays or the conversion of debt into equity.

Technical default - default triggered by breaches in debt (both private/bank and public/bond) covenants is usually due to violations of affirmative covenants such as net tangible worth, working capital or current ratios, rather than negative covenants such as 'negative pledges' or restrictions on disposals etc. (Citron 1992). A breach of covenants, which can trigger cross-default clauses, would normally

cause the entire borrowings of the company to be payable on demand. Lenders have the right to recall the loans immediately, renegotiate, or waive the breach in expectation of an improvement in the firm's business.

A more serious default is a substantive default triggered by the failure to meet interest or debt repayments when they fall. Insolvent firms can be rescued by informal procedures such as private workouts, with the support of bankers and/or creditors. Failing that, they can resort to formal insolvency proceedings, which could be creditor-led in the case of administrative receivership or firm-led i.e. bankruptcy protection.

A2.2.2. Informal insolvency proceedings: Private workout

No rescues can be effected without bank facilities. Bank rescues have played a valuable part in assisting a number of major companies to survive periods of difficulty due to recession, market changes or mis-management. In recent years, the Bank of England, through the 'London Approach'¹³, has played a major part in persuading banks to cooperate in rescues. The 'London Approach is designed to ensure that decisions about whether to call in the receivers on the one hand or to organise a 'workout' on the other hand, are orderly and well-founded. Workout is a term used here to describe a non-statutory i.e. private, agreement to extend financial support to a company which, without this support, would have to cease

¹³The key features of the London approach are: 1. Banks remain for the time being supportive and do not rush to appoint receivers, 2. Decisions about a company's future are made on the basis of reliable information which is shared among all parties to a workout, 3. Banks, and other creditors, work together to reach a collective view on whether and how a company should be given financial support, 4. Pain is shared on an equitable basis. Source: Pent Kent, director Bank of England and The Banker, March 1994.

trading (Kent, 1994). The objective is to maximise value for creditors by reducing receiverships. Workouts reduce the incidence of 'indirect costs' of financial distress. Indirect costs include lost sales and profits and inability to raise funds, as opposed to direct costs which can be measured with ease e.g. fees of lawyers, accountants and bankers (Warner, 1977). For example, in a receivership, publicity could severely damage a company's ability to trade, and the forced sale of assets would most likely be made at less than full value.

A workout would entail secured creditors not appointing a receiver and unsecured creditors not petitioning for a winding-up order. All creditors also have to refrain from pressing for repayment until the viability of the company is assessed and a consensus on a way forward is reached. Frequently, the first step before a full scale refinancing is attempted is the agreement of lenders to a 'standstill agreement'. This would take the form of *not* demanding repayment despite breaching of certain covenants (technical default) or actual default (substantive default), extending loan repayment for a short-term period, and provision of temporary 'rescue or working capital' facilities.

The London Approach for collective workouts has been claimed to be quite effective and has acquired an impressive track record over the past few years (Kent, 1994). Until recently, raising additional finance in the form of equity and new loans for rescue purposes was more common than private debt restructuring in the UK (Slatter, 1984).

A2.2.3. Formal or public insolvency proceedings

a. Involuntary proceedings: Administrative Receivership or Receivership

Bank debts commonly form the highest proportion of a typical UK corporate's debts and tend to be secured. Security is normally by way of fixed and floating charges over substantially all of the companies assets. Fixed charges cover fixed assets, goodwill and uncalled share capital whereas a floating charge 'floats' over assets that are changing and less-permanent in nature such as debtors, stocks and work-in-progress. Fixed charges entitle the holder to absolute right to the realisation proceeds whilst floating-charges entitle the holder only to the residue of proceeds realised from floating-charge assets after repayment of preferential creditors such as Value Added Tax (VAT), Pay As You Earn (PAYE), National Insurance Contributions (NIC) and salaries, and secured creditors.

Administrative receivership is primarily a recovery mechanism for an individual creditor, or a group of creditors, holding a floating charge. A bank/secured creditor may appoint either a fixed charge receiver or an 'administrative receiver' where a floating charge is held as well. Banks would prefer to appoint an administrative receiver (AR) to a fixed-charge receiver as an AR takes immediate effective control of the management of the indebted corporate. The AR has extensive rights over assets and power to manage the business as well as sell assets covered by the charge. In addition, he has the authority to implement a rescue plan designed to rescue the profitable parts of the business. In practice, banks will only appoint an AR if they are doubtful of recovering their monies or their security is in jeopardy.

b. Voluntary proceedings/bankruptcy protection

i. Administration

An administration order, where applied for by the directors and granted by the court, will allow an insolvent company to continue trading under the supervision of an administrator who serves the total interest of all creditors. The objective of administration can be one of three: 1. turnaround and the survival of the company and its business, 2. arrangement with creditors and shareholders to reorganise the business, 3. better realisation of assets than would be achieved on a winding up order (liquidation).

Generally, administration is aimed at securing a 'breathing space' as an immediate 'moratorium' is obtained upon presentation of the petition. The moratorium i.e. relief against creditors claims, lasts until the hearing of the petition or, if an administration order is granted by the court, until the discharge of the order. However, floating charge holders have the right to be given notice of petitions and the right to object and appoint an administrative receiver.

Administration has several advantages over bank-led rescues such as receivership and private workout in that the administrator cannot be pressured into payment of compensation for loss of employment and closure costs. In addition, an administrator has the power to dispose charged property, property held under hire purchase or held subject to retention of title.

ii. Scheme of arrangement

In a scheme of arrangement, governed by S425 Companies Act 1985 (CA 85), and subject to approval by the court, creditors would be asked to waive or capitalise part of the debt and/or convert short (unsecured) to long-term (secured) debt. Creditors may find they have the choice of either liquidating the company and receiving a small dividend or agree to the scheme of arrangement with a view to receiving more. This is a rarely used procedure as it is complex, expensive, and cumbersome to operate. Further, the firm is exposed to the risks of a winding up order anytime before the sanctioning of the scheme by the court. In contrast, petitioning for an administration order achieves the same objective whilst the petitioner is guaranteed full protection by way of an 'immediate moratorium'.

A framework similar to the S425 CA 85 scheme offered by the Insolvency Act 1986 is the voluntary arrangement scheme, which like the S425 scheme, is initiated by company directors requiring court approval.

iii. Creditors Voluntary Arrangement and Compulsory Liquidation

The outcome of financial distress is either recovery or liquidation of the firm. Liquidation is a process whereby the assets of the company are realised and distributed among its creditors according to their statutory priority and entitlements. Liquidation can be effected through a creditor voluntary arrangement (CVA) or a compulsory liquidation order. A CVA is a situation where the directors recommend to shareholders the passing of an extraordinary resolution to put the company into voluntary liquidation. This is followed by creditors' meetings and once approved liquidation is the responsibility of the creditors. CVA

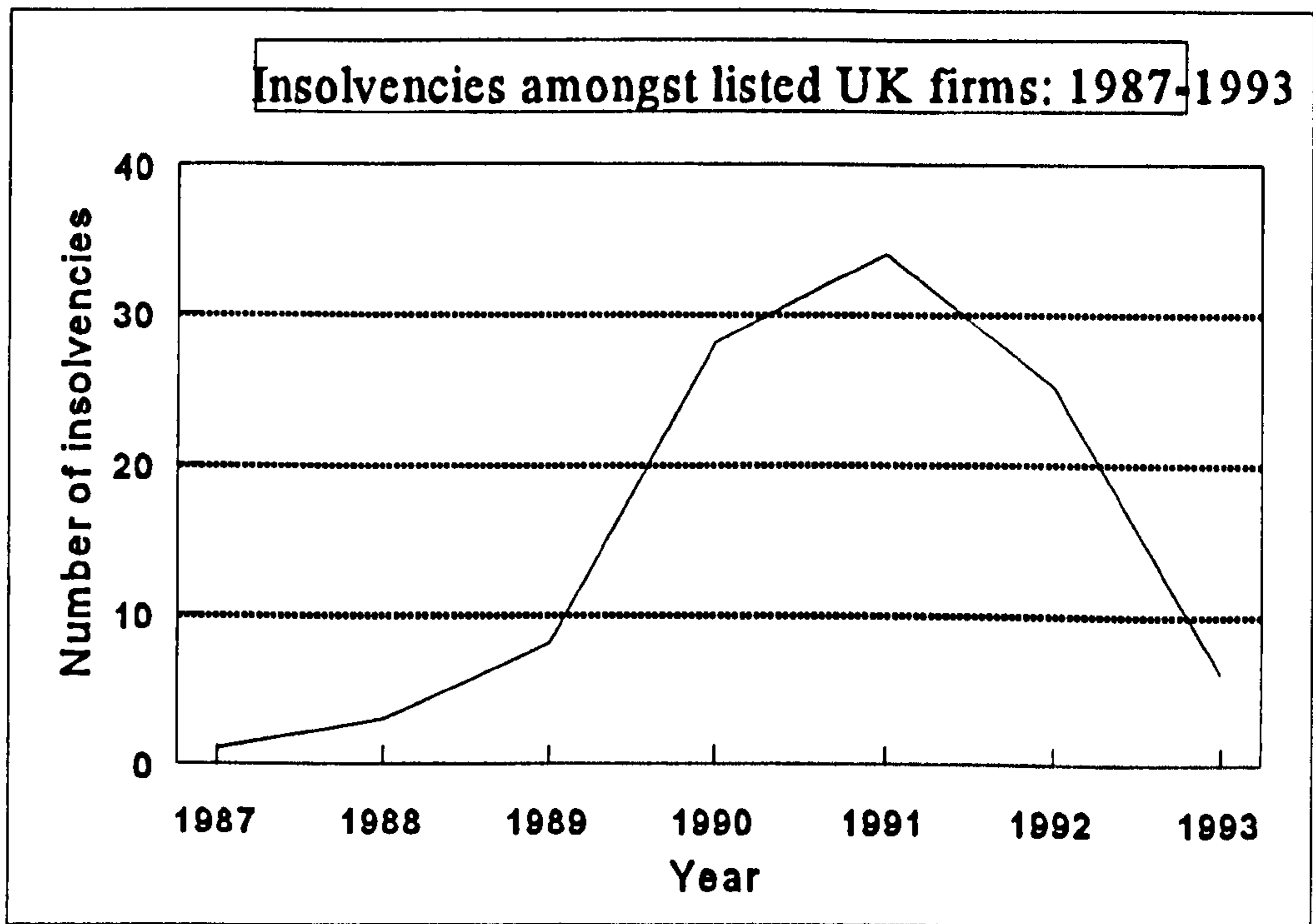
is the most commercially effective, and hence the most used, corporate insolvency procedure.

In a compulsory liquidation, creditors can petition to wind up the company where the company is unable to pay its debts. This is an expensive procedure as an Official (DTI) Receiver has to be appointed to oversee the liquidation process. Compulsory liquidation is only used when serious management wrongdoing or fraud is suspected.

Figure 2.2 below shows the incidence of public insolvencies amongst UK listed firms in the period 1987-1993. As public insolvencies exist only post the Insolvencies Act 1986, which became effective from mid 1987, and due to a healthy economy, the incidence of public insolvencies is low in the 1987-1988 period. The recession of the late 80s and early 90s saw a steep rise in the number of public insolvencies, which subsequently declined in the 1992-93 period.

Figure 2.2: Public Insolvencies of Listed UK Firms: 1987-1993

Source: Extel Financial, London Stock Exchange Official Yearbook, London Stock Exchange Quarterly Review, and Datastream International.



3.1. Introduction

When a firm falls from a superior performance position to an extremely poor position on any appropriate performance criterion, it manifests fundamental problems with the firm's management and strategies. However, given that the firm is performing badly, how should management respond? Management can either 'do nothing' and sit tight in hope of an upturn or restructure to recover rapidly from performance decline. However, 'masterly' inaction may lead to further deterioration in firm performance (Schendel et al, 1976).

Rescues and recovery of distressed firms would usually involve some management changes entailing dismissal of incompetent managers, rationalisation resulting in redundancies and closures of loss-making operations, and reduction in borrowings by selling-off peripheral businesses or through fresh capital injection. The business for sale may need to be transferred ('hived down') to a newly incorporated subsidiary, the shares of which are then sold. However, the rescue would only be successful if, after such disposals, the rump of the group remains viable and can be made profitable.

Stuart Slatter (1984) propounds ten elements of successful recovery strategies. They are: 1. appointment of a new chief executive, 2. imposition of strong financial control, 3. cost cutting including increasing margins, 4. asset disposals to raise cash, 5. debt restructuring [elements 2 to 5 aim at 'stemming the bleeding'], 6. organisational change and decentralisation, 7. reassessing products/markets, 8. improved marketing, 9. attracting additional investment, and

10. acquisitions. In other words, the 'rescue' stage (comprising elements 1 to 5) of the recovery plan is to raise cash via asset-reduction, cost-reduction, and debt restructuring, whilst the 'rejuvenation' stage (comprising elements 6 to 10) centres on profit improvement through improved operations, reshaped product/market mix and improved organisation structure, and finally a return to growth via acquisitions, new product developments and increased market penetration.

Nelson and Clutterbuck (1988) consider corporate turnaround a three-stage process. First, achieve survival through strategies to contract and rationalise the business to provide a financial breathing space, Second, refocus to a viable core, through divestments, investments and new product development. Third, achieve long term expansion through growth-oriented strategies such as internal investment or acquisitions. A similar schema is also proposed by Hoffman (1989).

Corporate turnaround models such as Slatter's and Nelson and Clutterbuck's seldom work in a clockwork fashion. Frequently, firms facing performance decline have to respond rapidly, usually requiring a mixture of strategies such as cost cutting, refinancing, and investment strategies, to return the firm to profitability within a short period of time. This means that the various turnaround strategies are not necessarily sequential but often are taken simultaneously. In addition, not all strategies are relevant to all the different levels of decline. There may also be interactions between the various strategies.

Corporate rescue and recovery, in practice, employ strategies which are essentially corporate restructuring strategies, a field well researched by financial economists in the US. Hence, for the purpose of this study, corporate rescue and recovery strategies are subsumed under the generic heading of corporate

restructuring strategies..

The objective of this chapter is to identify the range and variety of restructuring strategies reported in the literature. The empirical evidence and main conclusions from these studies are discussed later in Chapter 5, in the context of the effectiveness of restructuring strategies. The strategic management and finance literatures on corporate restructuring strategies are reviewed next. A summary of this review is included as Appendix 3.1 of this chapter. This research encompasses a comprehensive corporate restructuring framework, synthesising both the strategic management and finance literatures. It covers the generic strategies of managerial, operational, asset and financial restructuring.

3.2 Managerial restructuring

Top management change is widely quoted as a precondition for successful turnarounds (Schendel et al, 1976; Hofer, 1980, Bibeault, 1982; Slatter, 1984). When old ways of operating need to undergo radical change, it is often difficult for top management responsible for developing the existing system to change their habits and institute the necessary reforms. Often, banks and creditors will continue financial support only if they are confident that the management team can manage the crisis in hand. A change in top management is tangible and reassuring evidence to bankers, investors and employees that the firm is aware of the gravity of its predicament and that something positive is being done to improve its performance, even though the cause of performance decline may have been beyond the incumbent management's control (Slatter, 1984). An inverse relation is found empirically between the probability of management change and firm's

stock performance (Coughlan and Schmidt, 1985; Warner et al; 1988). In other words, the worse the firm's stock performance becomes the higher is the probability of a management change. Keasey and Watson (1987), Gilson (1989, 1990), and Murphy and Zimmerman (1993) find significant top management changes in distressed firms.

3.3 Operational restructuring

The strategic management literature provides empirical support for an overlapping two stage approach to corporate turnarounds (e.g. Robbins and Pearce II, 1992; Arogyaswamy et. al, 1995). The two stages are the efficiency/operating turnaround stage based on cost and asset reduction, and the entrepreneurial/strategic stage based on asset restructuring or product/market refocusing (e.g. Bibeault, 1982; Slatter, 1984; Robbins and Pearce II, 1992). The efficiency/operating turnaround stage aims to stabilise operations and restore profitability by pursuing strict cost reductions and operating asset reductions. The entrepreneurial/strategic stage aims to achieve long term growth through restructuring the firm's strategic asset portfolio. Our research classifies efficiency/operating measures as operational restructuring and entrepreneurial/strategic measures as asset restructuring.

Operational restructuring comprises cost-reduction, revenue-generation and operating asset reduction strategies. The objective is to improve efficiency and margin through bringing down overheads in line with volume (Slatter, 1984, p: 99). Operational restructuring is, generally, the first rescue strategy implemented as there is no point in assessing the strategic health if the firm goes bankrupt in the

near term (Hofer, 1980). Efficiency measures are directed at both maximising output (revenue) and minimising input (resources such as costs and assets). Cost reduction strategy to reduce costs, restore profitability and improve cash flows is the core of corporate rescues. Cost reduction specifically entails cutting direct costs and overheads, including headcounts, and interest charges. Cost reduction may be sufficient where the firm is weak operationally but not yet in distress.

Next, revenue generating strategies may be pursued. The focus is primarily on existing lines of products, initiating price-cuts (or raising prices where demand for products is price insensitive) and increasing marketing expenditure to stimulate demand (Hofer, 1980). Due to data availability problems, revenue-generating strategy is not explicitly studied in this research. For example, sales growth can potentially be used to proxy for revenue growth but the effect of asset restructuring, such as acquisitions, obscures operational revenue generating efforts.

When the firm is operating well below capacity, asset reduction to improve utilisation and productivity of assets is imperative. Also, generating cash flow via asset reduction is vital for turnaround in the case of firms in severe financial distress. Asset-reduction can be operating or strategic in nature. The latter is discussed in the next section. At the operating level, operating asset reduction refers to business unit level sale, closures and integration of surplus fixed assets such as plant, equipment and offices, and reduction in short term assets such as inventory and debtors. The objective is to contract assets employed to match reduced volumes and thereby improve asset utilisation at the operating level (Bibeault, 1982; Hofer, 1980; Schendel et al, 1976).

The objective of operational restructuring strategies is primarily to generate, in the short-term, higher cash flow and profitability. In summary, it may be sufficient for firms merely in poor performance, but not yet in crisis, to adopt cost reduction and revenue-generating strategies to recover. However, if the firm is in distress, or there exists excess capacity or there are unprofitable product lines, operating asset reduction may be necessary to achieve a turnaround.

3.4 Asset restructuring

According to the strategy literature (see Bowman and Singh, 1993), strategic asset/portfolio restructuring covers reorganising the firm into self-contained Strategic Business Units; divestment of lines of businesses not fitting the core businesses; acquiring companies that relate to and strengthen the core; discontinuing unpromising products; and forming strategic alliances, joint ventures and licensing agreements¹⁴. In addition, distressed firms may have the option of merging with other firms, being taken over in a hostile bid or being bought-out by its own management (MBO's).

As discussed earlier, the strategic management literature suggests a two-stage turnaround strategy (see Section 3.3). The second entrepreneurial/strategic stage resembles the asset restructuring found in the finance literature, as it refers to a major reconfiguration of the firm's assets. This covers asset divestment and investment.

¹⁴ Asset restructuring refers to strategic or long term asset restructuring and excludes short term asset restructuring such as reduction of debtors and stocks which is part of operational restructuring.

3.4.1 Asset divestment

According to the strategic management literature, where the firm is in distress and/or where strategic health is weak e.g. where present capacity far exceeds long term revenue potential or assets are in declining product/markets, asset reduction is imperative for recovery (Hofer, 1980; Pearce II and Robbins, 1993). Asset-reduction at the portfolio (corporate strategic) level covers, in the main, corporate divestment of subsidiaries/divisions. The objective at this level may be to divest non-profit generating assets (and halt cash drains), non-core assets or even profitable assets for the purpose of raising cash to alleviate financial distress and fund new strategic investments. Where the firm is in distress, corporate strategy takes second priority to alleviation of financial distress and survival. Divestment of subsidiaries is claimed to be the most common turnaround strategy by all but the smallest firms (Slatter, 1984). Divestment can take the form of sell-off, management buyout, spinoff/demerger, equity carve-out and sale and leaseback.

i. Sell-offs

Sell-offs refer to complete and permanent disposals of parts of a firm's assets, normally a subsidiary company (see Wright and Thompson, 1987).. Duhaime and Grant (1984) find sell-offs to involve less profitable and more peripheral units of a diversified firm, and also to be related to the profitability of the parent firm ie. sell-offs represent a viable response to financial difficulties. Voluntary sell-offs are generally empirically shown to be related to efficiency improvements in the new sold-off entity (eg. Hite and Owers, 1983) and to generate significantly positive effects on selling and buying firms share prices

(Sicherman and Pettway, 1992)

ii. Management buyouts (MBO's)

Restructuring by way of Management Buyouts (MBOs) is suggested in the literature as related to inefficient companies (e.g. Duhaime and Grant, 1984; Seth and Easterbrook, 1993). MBO's 'incentive-intensive' management is posited as suitable for increasing firm efficiency and refocusing to core business for the bought-out entity (see Seth and Easterwood, 1993). Consistent with this, Liebeskind et al.(1992) found LBO firms to downsize corporate operations and forego excess growth to improve performance, but found little difference in refocusing between LBOs and non-LBOs firms. Wright and Coyne (1985), in a study of 111 UK MBOs up till 1983, find MBOs to facilitate firm (the MBO firm) reorganisation ranging from changes in management structure to employee levels, improvement in cash and credit control systems, and movements into new product areas which had previously been difficult to achieve. Their findings are supported by a subsequent study of 182 MBOs, over the period 1983-86, by Thompson, Wright and Robbie (1989).

iii. Spin-offs

Spin-offs, which involve the listing of an operating unit as an independent firm and distributing the shares to shareholders of the parent firm, are found to be associated with significant abnormal returns (see Hite and Owers, 1983). Gains can be attributed to elimination of diseconomies of scale among dissimilar operating units, contracting flexibility or efficiency (Hite and Owers, 1983), tax and regulatory advantages and/or resulting managerial efficiency (Schipper and

Smith, 1983). Typically, a parent firm relinquishes control over its subsidiary's assets after spinoff (e.g. Zeneca after its demerger from ICI).

iv. Equity Carve-Outs

Equity carve-out announcements, a situation where a portion of a wholly-owned subsidiary's stock is offered for sale to the public, are associated with a positive increase in shareholder wealth (see Schipper and Smith, 1986). This is often attributed to changes in asset management, better information dissemination of subsidiary performance, better market valuation of subsidiary's assets, changes in managerial incentive contracts, and ease of acquisition of the subsidiary by another firm.

v. Sale and leaseback

Firms facing performance decline may resort to sale and leaseback arrangements to raise cash whilst retaining the use of key assets via long term leasing contracts. Properties, plant and machinery and cars are popular items for sale and leaseback arrangements to tide over troubled times. In this form of divestment, although the legal ownership of the asset rests with the lessor, the lessee retains the economic use and benefit of the asset through paying agreed rental payments for a specific period (lease period), at the end of which the lessee may have the option of repurchasing the asset for a specified sum¹⁵.

3.4.2 Asset investment

In general, asset investments are feasible only for firms with strong

¹⁵We are concerned only with cash flow and not with the Balance Sheet effect, such as whether the lease is capitalised or not.

financial health and can be implemented only after corporate survival is assured. Asset investment covers operational and strategic investments. Associated with efficiency/productivity improvement, firms may upgrade their production facilities through building new plants and equipment or automating existing processes (Schendel et al, 1976; Hambrick and Schechter, 1983). Capital expenditure of this nature complements, rather than conflicts with, the cost-reduction strategy, as the common objective is enhancing efficiency/productivity, reducing unit costs and improving price competitiveness or profit margin. Though aimed at improving operational efficiency, internal capital expenditure is seldom made for short term purposes (Slatter, 1984). With strict financial control in operation during period of performance decline, only capital expenditure of the highest justification (e.g. central to survival in product/markets) may be approved. Capital expenditure is generally classified as 'organic' asset investment.

Strategically, firms facing performance decline may seek to acquire assets that fit their core businesses. The strategic objective is to refocus from unprofitable or unrelated businesses to a profitable core with long term profit potential. This stage is crucial for recovery by firms with ill-suited corporate strategy or mature or declining product/markets where a new strategic direction is imperative (Schendel et al, 1976; Hofer, 1980; Pearce II and Robbins, 1993). Acquisition is suggested as the most commonly used turnaround strategy for stagnant firms i.e. firms with poor financial performance but not yet in crisis, as acquisition is quicker to implement than an organic growth strategy (Slatter, 1984, p: 96).

3.5 Financial restructuring

Cash generation strategies e.g. asset divestment and equity issues, are commonly used strategies to alleviate financial distress, as proceeds are frequently applied to pay down firms' borrowings (Slatter, 1984). Extant strategy-based research on corporate turnarounds has paid scant attention to financial restructuring as an integral component of corporate turnaround strategy, as opposed to the finance-based research (e.g. Gilson, 1989; DeAngelo and DeAngelo 1990; John, Lang and Netter, 1992; Brown, James and Mooradian, 1993; Ofek, 1993; Franks and Tourous, 1994). This study incorporates financial restructuring as a key element of the corporate restructuring framework.

Financial restructuring is the reworking of a firm's capital structure to relieve the strain of interest and debt repayments. Financial restructuring, in this study, is separated into two strategies: equity-based and debt-based.

3.5.1 Equity-based financial restructuring

Equity-based strategies cover dividend cuts or omissions and equity issues i.e. rights issue, public offer or institutional placing. Firms in cashflow crisis tend to reduce or omit dividends for reasons of liquidity constraints, restrictions imposed by debt covenants, or strategic considerations e.g. to improve a firm's bargaining position with trade unions (DeAngelo and DeAngelo, 1990). DeAngelo and DeAngelo (1990) and John et al.(1992), empirically, find large firms respond to financial distress with rapid and aggressive dividend reductions. Recently, Jensen and Johnson (1995) find dividend cut is associated with financial decline and marks the beginning of a firm's restructuring efforts to reverse decline.

Failing companies are also found to be more likely to raise equity funds via share issues than non-failing firms because of pressure from creditors concerned with the security of their lending (Storey et al, 1987). The recent recession in the UK (1990-1992) saw a lot of financial restructuring activities by 'recession-scarred' firms involving the launching of rights issues. A small but significant percentage of these firms is thought to be in some form of financial distress. Colloroll, Lovell, and Pentos are a few that resorted to rescue rights issue to alleviate financial distress during the last recession but yet failed to recover. Funds may also be needed to repay banks where a covenant is breached or potentially breached if sufficient funds are not found to service debts.

3.5.2 Debt-based financial restructuring

Debt-based strategies refer to the extensive restructuring of firm debt. Firms restructure their debt either to avoid financial distress or to resolve an existing financial distress. Gilson (1989, 1990) defines debt restructuring as a transaction in which an existing debt is replaced by a new contract, with one or more of the following characteristics: 1. interest or principal reduced; 2. maturity extended; 3. debt-equity swap.

i. Increase/decrease in interest costs and reduction in principal

Increase/decrease in interest costs and reduction in principal are common in debt refinancing, including increases in rates of borrowing to the distressed firm simply because the risks of failure, and default, have increased. However, there are cases, such as the Euro Disney, where reductions in principal or interest

payments are made to resuscitate an ailing firm. Where principal amounts are reduced or loans cancelled, the distressed firm may be deemed in tax law to have received a taxable income. However, insolvent firms can obtain tax relief if such taxable income arises from a formal debt restructuring (Income and Corporation Tax Act 1971). The amount that may be excluded from income is the difference between the old and new debt amounts.

ii. Extension of loan or credit facilities

Extension of loan or credit facilities by bank creditors includes extension of the maturity term of loans (e.g. conversion of short term overdraft to longer term loans), provision of additional finance, and conversion from uncommitted to committed funding.

iii. Debt-equity swap

Debt-equity swap ie. converting debt to equity, including conversion to preference shares/convertible debt, is common in private and public debt restructuring as a means of relieving the distressed firm's debt burden (Gilson, 1990).

Debt restructuring is frequently accompanied by changes in covenants, increases in security cover and may be conditional on successful implementation of a rights issue and divestments.

iv. Changes in covenants

Changes in covenants arise when lenders require increased control over the distressed firm, mainly in the form of non-financial covenants such as dividend and capital spending restrictions, are also aimed at conserving the firm's asset base (Citron, 1992). In terms of financial covenant such as minimum net worth, existing

ones are often relaxed, to avoid their continuous breach, while addition of new ones is rare (Benish and Press, 1993).

v. Increase in security cover

Increase in security cover is aimed at inducing banks to extend and/or increase credit facilities sufficient for the company to continue in business. They may require the creation of debentures charging all the distressed firm's assets to them. Unsecured creditors have always been incensed by such rescue attempts which may leave them with nothing if the rescue fails, as banks will have a prior charge over all assets (Campbell and Underdown, 1991).

As discussed earlier, cash generative actions such as rights issue and asset divestments are frequently targeted at raising cash to pay down firm debts and thus alleviate its financial distress.

Debt restructuring is principally carried out in the form of a private workout in the UK. This is a private arrangement between a firm and its bankers aimed at refinancing and reconstructing the firm's debt finances (see Section A.2.2.2).

3.6 Capital reconstruction

Financial restructuring, especially involving debt-equity swap, would normally be accompanied by a capital reduction which results in the dilution of the equity stake held by existing shareholders. The objective of this other form of financial restructuring - capital reduction - is to enable debt-holders to own a major part of the restructured firm and to eliminate negative reserves. Capital reduction would typically take the form of reducing the nominal value of equity shares, splitting it into new shares and deferred shares, and subsequently

cancelling the deferred shares (Campbell and Underdown, 1991).

Poor performing and distressed firms tend to have low or negative reserves. Capital reconstruction schemes, requiring court approval, are attempts by distressed firms to repair their balance sheet via extinguishing past negative reserves. Firms involved in capital reconstruction schemes frequently claim the reparation of the balance sheet to pay dividends as their main purpose for this exercise (Campbell and Underdown, 1991).

The suitability of the above corporate restructuring framework is demonstrated in a study by John, Lang and Netter (1992) on the restructuring of large firms in response to performance decline. The corporate restructuring strategies applied by poor performing firms in their study in response to performance decline, adapted to the framework above, are shown in Table 3.1 below.

3.7 Summary of corporate restructuring strategies

Table 3.2 below summarises the generic and specific corporate restructuring strategies reviewed above. Managerial restructuring involves replacing inefficient managers responsible for performance decline. Operational restructuring entails employee layoffs or retrenchment, closures and integration of facilities. The objective is to cut costs and improve efficiency, stem losses, and tighten financial control. Asset restructuring can be broken down into asset divestment and asset investment.

Table 3.1 Restructuring by 46 large US firms in response to performance decline during the period 1980-1987.

Source: Adapted from John, Lang and Netter, 1992.

Strategies and Actions	% of firms adopting strategy
Financial Restructuring	
- reduce debt	39
- increase debt	9
- issue equity	7
Operational and Managerial Restructuring	
Contraction policies:	
- change in management structure	13
- job cuts	43
- wage cut	20
- plant closures	26
- reduce capacity	20
Expansion policies:	
- acquire raw materials	26
Others:	
- change marketing or pricing	10
- improve production efficiency and productivity	24
- change in inventory management	8
- improve quality	11
Asset/Strategic Restructuring	
Contraction policies:	
- emphasize core business / refocusing product/market	28
- sell assets, divest, spin off, sell business of subs.	63
- reduce capital expenditure	9
Expansion policies:	
- change in focus in product/market mix	20
- introduce new product	24
- enter new markets	15
- diversify	9
- embark on a joint venture	13

Table 3.2 : Corporate Restructuring Strategies: A Summary

Generic Strategy	Specific strategies	Objectives	Prior related research
Managerial	Management replacement	Remove inefficient managers responsible for decline.	Slatter (1984), Gilson (1989), Ofek (1993) Gilson and Vetsuypens (1993)
Operational	Layoffs, closures and integration of facilities.	Cut costs, improve efficiency to stem losses, and tighten financial control.	Bibeault (1982), Ramanujam (1984), Slatter (1984), Robbins et al.(1992), John, Lang and Netter (1992), Ofek(1993)
Asset	Acquisitions	Recovery strategy e.g. acquire competitors to increase sales etc, and 'survival' strategy e.g. taken over by a healthier bidder.	Stallworthy and Kharbanda (1988)
	Capital expenditure	Improve efficiency and productivity, and profits.	No prior studies.
	Management Buy-Outs	Realise cash to pay down debt, fund restructuring, and refocus to core.	Wright and Coyne (1985), Thompson et. Al (1989), Seth and Easterwood (1993), Liebeskind et al.(1992).
	Divestment	Realise cash to pay down debt (avoid bankruptcy) fund restructuring, and refocus to core.	Ramanujam (1984), Slatter (1984), Ofek (1993), Brown, James and Mooradian (1993), Lang Poulsen and Stulz (1995), Lasfer et al.(1996).
	Spin-Offs	Realise cash to pay down debt, fund restructuring, and refocus to core.	Hite and Owers (1983), Schipper and Smith (1983).
	Sale and leaseback	Realise cash.	No prior studies.

Table 3.2 : Corporate Restructuring Strategies: A Summary (Contd.)

Generic Strategy	Specific strategies	Objectives	Prior related research
Financial	Equity: Cut or omit dividends	Loosen liquidity constraints and/or restrictions placed by debt covenants	Slatter (1984), Storey et al.(1987), Gilson (1990), DeAngelo and DeAngelo (1990), Marsh (1992), Ofek (1993) and Christie (1994)
	Equity issues	Repay debt and increase working capital. Satisfy condition for debt restructuring.	Slatter (1984), Grinyer et. al (1988), John, Lang and Netter (1992).
	Debt: Debt restructuring	Alleviate financial distress by recontracting hard claims to soft claims and increase working capital.	Gilson (1990), Brown, James and Mooradian (1993), John (1993)

Divestments of subsidiaries and assets are primarily aimed at raising cash to pay down debt and fund restructuring and/or refocus to core business. In contrast, asset investments such as capital expenditure are targeted at efficiency and productivity improvements whilst acquisitions are aimed at moving away from existing unprofitable markets into profitable or growth markets. In terms of financial restructuring, dividend cuts/omissions are commonly triggered by liquidity constraints or restrictions imposed on the firm by debt covenants. Where cash generated via asset divestment and cash conserved via dividend cuts/omissions are insufficient to cover restructuring costs or debt servicing, firms

may have to resort to equity issues to raise the requisite funds. Frequently, successful fund raising via equity issues and divestments are a precondition for creditors' agreement to restructure their lending. Debt restructuring is normally a final resort for troubled firms and is aimed at alleviating financial distress through recontracting hard claims into soft claims and improving the level of working capital. Hard claims are binding contracts with fixed payment obligations e.g. term loans and payment of interests, whilst soft claims are non-binding contracts without any financial commitment to make payments eg. payment of dividends.

This chapter also highlights that the various turnaround strategies are not necessarily sequential but often are taken simultaneously. In addition, not all strategies are relevant to all the different levels of financial decline. Poor performance firms may require relatively fewer restructuring strategies than distressed firms. Whilst it may be sufficient to restructure the operations of poor performance firms, drastic asset and financial restructuring may be necessary to turnaround distressed firms. There may also be interactions between the various strategies. For instance, lenders often insist on successful cash generative actions such as divestments and rights issues as a key condition of restructuring their debt.

In the next chapter, we review the literature on what determines managers' restructuring strategy choice in the wake of performance decline.

Appendix 3.1 : Review of distress related studies: Restructuring strategies

Studies	Focus of restructuring			
	Managerial restructuring	Operational restructuring	Asset restructuring	Financial restructuring
Argenti (1976)	Change top management	Cut back in volume.	Abandon/sell assets or projects.	Cut gearing Debt
Carrington and Aurelio (1976)		Cost cutting		Debt renegotiation
Hamermesh (1977)	Organisational and management change	Efficiency improvement.	Product/market strategy	
Schendel et al.(1976)	Organisational and management change.	Marketing strategy, plant expenditure, increase in efficiency.	Diversification, divestiture, and vertical integration through acquisition.	
Bateman (1979)	Organisational and management change, simplify or reposition firm's mission(strategy)	Cost-cutting	Liquidate fixed assets	
Graham and Richards (1979)	New CEO, broader board of directors.			

Appendix 3.1 : Review of distress related studies: Restructuring strategies (contd.)

Studies	Focus of restructuring			Equity
	Managerial restructuring	Operational restructuring	Asset restructuring	
Hofer (1980)	New top management.	Revenue generating (marketing), cost-cutting.	Asset reduction, focus on strategic /market niche and increase in market share.	Debt
O'Neill (1981)	New organisational and management structure.	Cost controls	Restrict growth (e.g. reduce acquisitions). New business development (e.g. incur capital expenditure).	
Ramanujam (1984)		Operating changes in -costs -stocks -debtors - staff	Asset reduction Acquisitions	
Melin (1985)		Prune product line, market expansion, increase capacity	New owners, increased R&D investment, acquisition.	

Appendix 3.1 : Review of distress related studies: Restructuring strategies (Contd.)

Studies	Focus of restructuring			
	Managerial restructuring	Operational restructuring	Asset restructuring	Financial restructuring
O'Neill (1986)	Change top management	Cost-cutting. Marketing promotion, and launch new products.	Divestment.. Growth - acquisitions	Debt Equity
Grinyer, Mayes and Mckiernan.(1988)	Changes in management and organisation	Stronger financial control, new product/market focus. improved marketing, and reduced costs	Acquisitions	Debt reduction Rights issue and debt reduction
Gilson (1989)	Management replacement			
Bonnier and Bruner (1989)	Management changes			
Gilson (1990)				Public and public debt restructuring
Wruck (1990)	Organisational changes including change of CEO.	Restructure - close facilities and lay off employees.	Change firm strategy - refocus operations, divest and invest.	Reshape financial structure - private workout and bankruptcy.

Appendix 3.1 : Review of distress related studies: Restructuring strategies (Contd.)

Studies	Focus of restructuring				Equity
	Managerial restructuring	Operational restructuring	Asset restructuring	Financial restructuring	
DeAngelo and DeAngelo (1990), and DeAngelo and DeAngelo and Skinner (1992)					Dividend cut
John, Lang and Netter (1992)	Change management structure.	Layoffs, product/market strategy, close plants, cut wages, reduce capacity, change marketing and/or production methods, and improve quality	Contraction policies - divest, spinoffs, return to core, reduce capital expenditure. Diversify and enter joint venture.	Increase/decrease debt	Issue equity

Appendix 3.1 : Review of distress related studies: Restructuring strategies (Contd.)

Studies	Focus of restructuring			
	Managerial restructuring	Operational restructuring	Asset restructuring	Financial restructuring
Robbins and Pearce II (1992)		Retrenchment stage- cost reduction:- improve efficiency, eliminate products and cut head count.	Retrenchment stage- asset reduction	Debt Equity
Sicherman and Pettway (1992)			Divestments	
Brown, James and Mooradian (1993)				Public and public debt restructuring
Gilson and Vetsuypens (1993)	CEO replacement and top management compensation changes			
Brown, James and Mooradian (1994)			Asset sales	

Appendix 3.1 : Review of distress related studies: Restructuring strategies (Contd.)

Studies	Focus of restructuring			
	Managerial restructuring	Operational restructuring	Asset restructuring	Financial restructuring
Franks and Tourous (1994)				Debt restructuring both public and private.
Lang, Poulsen and Stulz.(1995)			Voluntary asset sales	
Lasfer, Sudarsanam and Taffler (1996)			Divestment	

Chapter 4. DETERMINANTS OF RESTRUCTURING STRATEGY CHOICE: - THEORY AND EMPIRICAL EVIDENCE

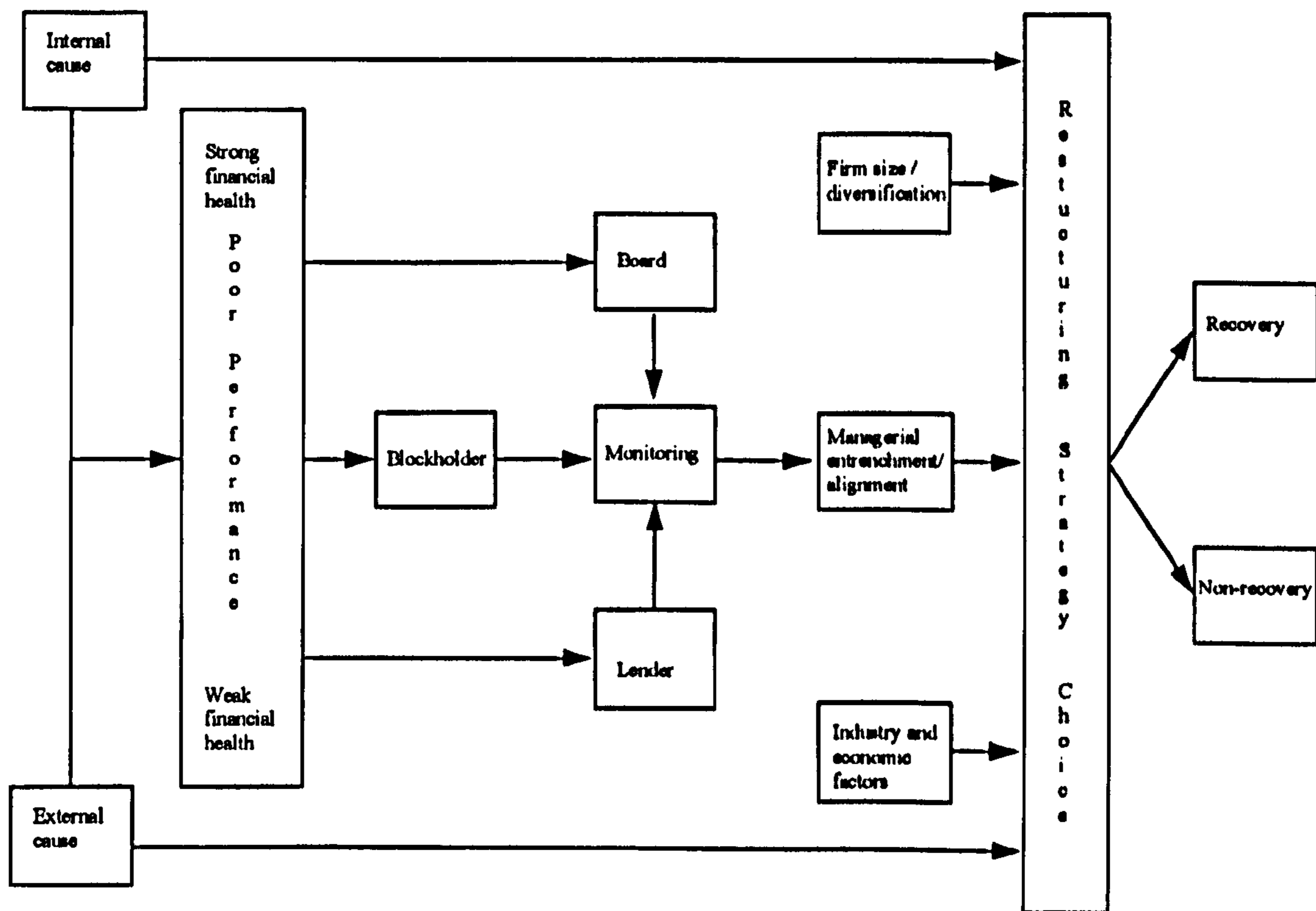
4.1 Introduction

Although the literature prescribes a range of corporate restructuring strategies for firms facing performance decline, few studies to date have explored comprehensively and empirically the determinants of corporate restructuring strategy choice.

This chapter documents a comprehensive literature review, aimed at finding out what could possibly influence managers' choice of restructuring strategies. From distilling and synthesising extant studies, a comprehensive determinants framework is adopted for this research. This framework is capable of capturing the complex interplay of forces influencing restructuring strategy choice. It seeks to enable firms suffering from performance decline to design feasible restructuring programmes to achieve turnaround. This framework is illustrated in Figure 4.1 and a summary of the literature review is included in Appendix 4.1. In this comprehensive framework, managers' restructuring strategy choice is conditional upon firm-specific agency monitoring mechanisms and other contextual factors. Stakeholders forming the firm-specific agency monitoring framework are lenders, managers, block shareholders and the board of directors. Other firm stakeholders such as employees, customers, suppliers, tax authorities and regulators are not included as their role in firm monitoring is minimal and not easily amenable to

empirical examination. Contextual factors impacting on strategy choice are causes of decline, severity of decline, firm size, industry and economic condition during the turnaround period.

Figure 4.1: Agency monitoring and contextual factors influencing recovery strategies



4.2 Agency monitoring mechanisms

The choice of turnaround strategies is contingent upon a number of factors. Since different strategies may have different, and often conflicting, welfare

implications for managers, shareholders and lenders, the choice of any strategy can only be made as a trade off among these contending stakeholders. The restraints on any single stakeholder group such as managers maximising their own self-interest to the detriment of other stakeholders is a function of the governance structure and the mechanics of agency monitoring in a firm (Gilson, 1990). Thus, an understanding of the nature and sources of these restraints is necessary to make the appropriate turnaround strategy choices.

The restraints on managerial choice of turnaround strategies may be examined within the context of the agency conflicts among shareholders, managers and lenders. The motivations of these players also provide the impetus to the pursuit of turnaround strategies so that firm value is enhanced and its ability to meet its financial commitments is restored.

While both lenders and shareholders have a common interest in restoring firm viability and its ability to preserve their investment in the firm, in the turnaround process either group may gain at the expense of the other. Shareholders may benefit from a transfer of wealth from creditors when managers undertake risky investments (Myers, 1977). Likewise, lenders may benefit from a wealth transfer from shareholders when managers sell assets to pay off debts (Lang et al, 1995). Shareholders suffer from a loss of wealth when the option value¹⁶ attached to assets is extinguished when the assets are sold. Similarly, managers may pursue turnaround strategies which least harm them while the burden of turnaround is

¹⁶Option value refers to the potential value increase if assets sold were retained by the firm.

borne by shareholders or lenders or both. Managers' pursuit of self-serving objectives may manifest itself in their choice of strategy. However, managerial discretion in choice of strategy may be tempered by the agency control mechanism in place in the firm.

As discussed in Chapter 3, the turnaround options broadly available to declining firms include operational, asset, managerial and financial. Not all of these actions will appeal equally to shareholders, managers and lenders since they demand different degrees of sacrifice from these stakeholders during the turnaround process.

Managerial restructuring, e.g. replacement of the top managers, is obviously unlikely to be favoured by managers and where the governance structure is weak and the management is entrenched such replacement may not happen. Similarly, where financial restructuring involves additional borrowing or dilution of the covenants protecting existing lenders they are likely to resist such debt restructuring. On the other hand, turnaround based on fresh infusion of equity is likely to be preferred by lenders but frowned upon by shareholders. Dividend cuts may be loathed by shareholders but supported by lenders.

Asset restructuring in the form of divestments may be favoured by shareholders provided the divestment proceeds are not used to pay down debt. Lenders may support divestment provided their debt is paid off. New investments of a high risk nature financed by new debt or existing cash resources of the firm may be preferred by shareholders but not necessarily by lenders.

4.2.1 Impact of lender monitoring on managerial choice

In the agency model of the firm posited by Jensen (1989) a highly leveraged firm will react faster to performance decline than less leveraged ones due to a desire to avoid breaching or to resolve an existing breach in, debt covenants. This early response preserves the going-concern value of highly leveraged firms as compared to less-leveraged firms.

Ofek (1993) examines the role of lender monitoring within the agency paradigm in influencing the choice of restructuring strategies of poorly performing companies in the USA. He finds that high gearing significantly increases the probability of financial and operational restructuring. Gilson, John and Lang (1990) find no relation between gearing and financial restructuring¹⁷.

High leverage is also found by Storey et al.(1987) to be more positively associated with equity rights issues (i.e. financial restructuring) in failing firms than in non-failing firms. They attribute this to the monitoring pressure from bank creditors who are only willing to continue financial support conditional upon shareholders sharing a part of the burden of turnaround.

4.2.1.1 Debt characteristics and their impact

Impact of debt on managerial choice of turnaround strategies may depend on the characteristics of debt such as ownership, maturity structure and security

¹⁷ A potential explanation for this inconsistency lies in the difference in length of distress examined in the two studies. Ofek (1993) studies the short term restructuring actions in the year of performance decline whereas Gilson et al.(1990) examine firm actions following three years of low performance.

available¹⁸. Debt ownership by informed bank creditors is likely to promote more efficient monitoring than by other types of debt holders. This increased efficiency arises from the banks' close relations with firms and their access to private information, a right established by loan covenants or through ongoing bank relationship.

Bank lenders

Banks' reputational capital provides them with the economic incentives to monitor firm actions. Hirschey et al.(1990) find that the higher the proportion of bank debt in total debt the higher is the positive return on announcement of a sell-off to the divestor shareholders. This superior valuation is attributed to the more effective and credible monitoring by banks with a large stake.

James (1987) argues that banks provide some special services not available from other lenders. He finds evidence of a larger positive stock price reaction to new bank credit agreements than to announcement of private placements or public straight debt offerings. In Gilson's (1989) study bank lenders frequently initiate senior management changes in distressed firms.

Short term lenders

Maturity structure of debt is likely to influence the borrower firm's

¹⁸Publicly traded debt which is prevalent in the US is restricted to large firms in the UK. Also, as information on UK public debt is scarce, the impact of public debt monitoring on strategy choice is not examined in this study.

restructuring decisions since the greater the proportion of short term debt the greater is the likely level of monitoring. The credit renewal process associated with short term debt subjects firm managers to more frequent monitoring than long term debt and increases the bargaining power of lenders over managerial decisions such as liquidation (Diamond, 1993, Rajan, 1992 and Gertner and Scharfstein, 1991) and the use of proceeds from asset sales (Brown et al, 1994). Empirically, Ofek (1993) finds that short term leverage increases the probability of operational and managerial restructuring strategies in poorly performing firms.

Secured lenders

In addition to debt ownership and maturity structure, the security for the debt may also impact on the restructuring decision. A high proportion of unsecured debt is likely to be associated with more effective monitoring because of the unprotected nature of this debt. Lack of security may induce more intense monitoring by unsecured lenders.

Leverage may have a positive and significant relation with the incidence of all four generic turnaround strategies. The primary motivation is debt repayment. Lenders are expected to favour asset sales proceeds to be applied to debt repayment rather than retained by the firm. (Slatter, 1984; Lang et al, 1995). They are also likely to favour cut/omission of dividends and reduction in acquisitions to conserve cash, and/or equity issues to increase liquidity (Storey et al, 1987). Lenders may expect extensive asset sales, operational cost cutting and

management changes as a prerequisite for debt restructuring. Debt restructuring may be the last resort after exhausting other forms of restructuring.

4.2.2 Impact of ownership structure on managerial choice

The share ownership structure in a declining firm may provide an agency mechanism for controlling managerial discretion in the choice of turnaround strategy. Block shareholders may provide effective oversight leading to value maximising behaviour on the part of managers (Schleifer and Vishny, 1986). Where managers hold significant shares, their interests may be aligned to those of shareholders in general. The role of block shareholders as agency monitors has been studied by many researchers.

4.2.2.1 Managerial shareholding

Agency theory suggests that when corporate managers are also shareholders, their interests are aligned with those of shareholder interests (Jensen & Meckling, 1976). Managers, their fortune bonded to that of shareholders and forced to bear the wealth consequence of their sup-optimal actions, have greater economic incentives to enhance shareholder value.

Conversely, managerial entrenchment hypothesis (Jensen, 1986; Schleifer & Vishny, 1989; and Stulz, 1990) suggests that managers with substantial shareholding in a distressed firm would refrain from taking certain actions that would jeopardise their interests. An obvious action that they would not take is to

sack themselves. Consistent with this argument, both Ofek (1993) and Weisbach (1988) find a negative relation between managerial shareholding and top management changes. Ofek (1993) also finds managerial shareholding to be negatively associated with operational restructuring actions, lending further support to the entrenchment hypothesis.

The signalling hypothesis¹⁹, positing strong negative effects on shareholder wealth of dividend reductions and equity issues, suggests that managers of poor performance firms would refrain from cutting/omitting dividends (see DeAngelo and DeAngelo, 1990) or making an equity issue (see Schipper and Smith, 1986) unless absolutely necessary. Furthermore, if managers are also shareholders, there would be even greater disincentive for them to adopt equity-based financial strategies, as managers themselves as shareholders would have to stump up more money to keep the firm afloat. Rational shareholders would rather prefer lenders to bail out the troubled firm, as lenders with their higher priority claims are ahead of shareholders in reaping any rewards flowing from a cash injection.

4.2.2.2 Non-managerial block shareholding

Large shareholders provide an efficient mechanism for resolving the agency conflict which arises in a firm owned by atomistic shareholders (Jensen and Meckling, 1976). Demsetz and Lehn (1985) argue that as the size of large

¹⁹ Due to information imbalance between management possessing superior information and outside investors with inferior information, a decrease in dividends may be interpreted as signalling management's negative assessment of the firm's current performance and future prospects (Asquith and Mullins, 1986).

shareholding increases, monitoring effectiveness also increases. Hill and Snell (1989) suggest that blockholders possess both the incentive and voting power to limit managerial discretion and thus align managers' interests with those of the shareholders. Large shareholders have both the cost-effectiveness incentive and 'risk of financial loss' incentives to monitor as they stand to lose substantially from any value-destroying actions taken by management (Demsetz and Lehn, 1985)²⁰. Concentration of ownership with a few blockholders e.g. institutional investors, also facilitates the coordination of efforts in monitoring management performance²¹. Also, Schleifer and Vishny (1986) suggest that potential takeovers facilitated by large blockholders act as an effective device for monitoring management actions.

For the US, Hill and Snell (1989) find a positive relation between large shareholding and firm productivity. The positive valuation impact of large share acquisitions has been evidenced in a number of studies. Barclay and Holderness (1991), Mikkelson and Ruback (1985), Holderness and Sheehan (1985) and Choi

²⁰ For a small shareholder to monitor management actions in diffusely held firms, he/she will have to bear the entire cost of monitoring whilst the economic benefits are shared by all shareholders. To mitigate this 'free rider' problem, share holding must be large enough to ensure that the benefits derived from monitoring are commensurate with the costs involved. This implies that monitoring is only cost-effective for large shareholders such as institutional and other blockholders.

²¹ The City (institutional investors) are also frequently accused of passive and short-termist behaviour. They are thought to be more interested in short term dividends and stock dumping (sell-out on a takeover bid) than in taking an active role in the long term future of the firm. However, recent active debate on governance issues and some high profile interventions in corporate policy decisions by institutions in both the US and UK signal a new trend in institutional activism.

(1991) report, for the US, that block acquisitions in excess of 5% generate significant wealth gains for target shareholders. For the UK, Sudarsanam (1996) reports similar results.

Bethel and Liebeskind (1993) report that block share ownership is positively associated with corporate restructuring. In the UK, Sudarsanam (1995b) finds substantial asset, financial and managerial restructuring following large block acquisitions and value increases attendant upon such acquisitions are maintained or enhanced over the following three years. However, Ofek (1993) finds a negative relation between block shareholding and restructuring actions. On further analysis, he finds only a significant negative relation between institutional investors and the probability of operational and managerial restructuring. He suggests the results are consistent with Pound's (1988) finding that institutional investors tend to support top management in proxy contests.

Block shareholders may be institutional or non-institutional, and associated with incumbent management or independent of it. Agency monitoring effectiveness varies across these different block shareholder categories.

Institutional shareholding

Agency theory suggests that institutional blockholders' expertise allows them to monitor management actions at a lower cost than atomistic shareholders could. Consistent with this argument, McConnell and Servaes (1990) find a significant positive relation between Tobin's q and the level of institutional

holding. Agrawal and Mandelker (1990) provide evidence of a positive relation between institutional ownership and stockholder wealth effects of various types of antitakeover amendments in target companies. Jarrel and Poulsen (1987) show that firms that adopt the most value-reducing forms of antitakeover charter amendments also have lower institutional shareholding than do other firms. Brickley et al.(1988) find evidence that institutional investors who do not have business dealings with corporate management are more likely to vote against antitakeover amendments. All these US-based results are consistent with the reduction of agency costs due to large shareholders monitoring²². However, Ofek (1993) finds a negative relation between institutional shareholding and restructuring actions. As discussed earlier, Ofek claims his results to be consistent with Pound's (1988) finding that institutional investors tend to support top management in proxy contests.

Associated and unassociated non-institutional blockholders

Shivdasani (1993) emphasises the need to differentiate associated blockholders from those non-associated. Shareholders associated with incumbent management, e.g. family trusts or company pension funds are less likely to provide effective monitoring of managers than unassociated shareholders. Shivdasani

²² Pound (1988) provides counterarguments for a less effective monitoring role for institutional and large shareholders due to their being passive investors or having other business dealings with the company which lead to a conflict of interest detracting from effective monitoring. Mallette and Fowler (1992) also report that high levels of institutional shareholdings are more positively associated with the adoption of antitakeover poison pills than lower levels of institutional shareholding.

(1993) finds evidence that unassociated shareholders increase the probability of hostile takeovers. Similarly, Ofek (1993) finds different shareholder types to have different impact on restructuring actions. Hence, there is a need to separate non-managerial block shareholding into institutional, non-institutional unassociated and associated block shareholding.

Past event studies suggest shareholders frown upon certain strategies that are painful to themselves such as dividend cut/omission (Asquith and Mullins, 1986; DeAngelo and DeAngelo, 1990), equity/rights issue (e.g. Schipper and Smith, 1986) and asset sales where proceeds are utilised to pay down debts (Lang et. al. 1995). In all these studies shareholders react negatively to the respective event announcements. Equity holders' dislike for equity issues is understandable as it amounts to 'throwing good money after bad' money. Indeed, UK investors are claimed to be risk-averse and have rarely been willing to subscribe to new capital in distressed firms (Kent, 1994). Equity owners seem no more interested in dividend cuts or omissions than in equity issues. According to the dividend clientele hypothesis²³ and the information-content or signalling hypothesis²⁴ management would cut dividend only as a last resort. The evidence broadly suggests that equity investors dislike dividend reductions and equity issues, and

²³ Miller and Modigliani (1961) and Black and Scholes (1974) contend that investors may, for institutional or tax reasons, prefer dividends to capital gain.

²⁴See Modigliani and Miller (1964). The signalling hypothesis predicts that dividend changes convey information about cash flows i.e. a dividend increase (decrease) conveys favourable (unfavourable) information about the current and/or future cash flows of the firm. Empirical evidence in support of the information content hypothesis is found, amongst others, by Healy and Palepu (1988), Asquith and Mullins (1983), Kalay and Lowenstein (1985).

would prefer firms to resort to other sources to raise cash such as asset reduction and reduced consumption of cash via operational restructuring.

4.2.3 Impact of corporate governance structure on managerial choice

Corporate governance structure as a monitoring mechanism to reduce the agency problem between shareholders and managers has recently received much attention. The UK Cadbury Report on the Financial Aspects of Corporate Governance defines corporate governance structure as the checks and balances within the structure of the company, especially at the board level, which assist directors in fulfilling their duty to act in the interests of the company and guard against undue concentration of power among top managers. Composition of the board of directors is an important part of this structure and may enhance the policing effectiveness of the governance structure. Board composition is therefore likely to impact significantly on the choice of turnaround strategies.

The Cadbury Code suggests a strong board to be one where there is division of power at the top so that no one person has unfettered power of decision making. However, boards of directors differ in a number of ways: the leadership of the board by an executive or non-executive chairman and the separation of the roles of the chairman of the board and the CEO, and the relative importance of executive versus non-executive directors. Strong or weak governance structures in turn may lead to managerial entrenchment or incentive-alignment i.e. managers' incentives are aligned to those of shareholders.

Dual CEO and non-executive Chairman

Where one person combines the roles of board chairman and CEO his or her powers are considerable. This duality of roles can promote focused objectives and a clear line of command. On the other hand, duality may strengthen management entrenchment, reduce the oversight function of the board and weaken the governance structure. The Cadbury Code suggests that a strong governance structure exists when the roles of Chairman and CEO are separated whereby no one person has unfettered powers of decision. In other words, a combined Chairman and CEO structure is seen to lead to managerial entrenchment.

Mallette and Fowler (1992) find support for the entrenchment hypothesis in their empirical study with duality increasing the probability that poison pills are adopted whereas separation diminishes the probability. However, Rechner and Dalton (1989,1991) find no significant difference in firm performance between dual and non-dual firms.

Non-executive Chairman

If the Chairman and CEO positions are indeed separated, can we rule out managerial entrenchment? The answer to that question depends on whether the Chairman is in an executive or non-executive capacity. In the case of a non-executive Chairman, we can argue that although there is division of power at the corporate head, monitoring from the 'outside' by a part-time uninformed

Chairman may lead the CEO to wield substantial executive control over the firm. Such a weak board structure is expected to lead potentially to CEO entrenchment and its accompanying malaise ie. managers pursuing self-serving interests. However, the Cadbury Code does not cover the nature of the Chairman's position.

Proportion of outside directors

According to Fama and Jensen (1983), the separation of decision management and decision control²⁵ in the decision making process can alleviate the agency problem. While inside directors are responsible for decision management, decision control should be left with outside directors. Outside directors have an incentive to monitor management actions since they have staked their reputation as professional corporate referees. Consequently, the higher the proportion of non-executive to executive directors, the more effective would be the board monitoring of management. Indeed, the Cadbury Code emphasises the importance of non-executives carrying a significant weight in the board's decision. It follows that the higher the proportion of outside or non-executive directors in a firm's board the stronger would be the firm's governance structure.

Empirically, Weisbach (1988) finds that CEO turnover is highly correlated with the proportion of outside directors to inside directors. The monitoring function of outside directors is also supported by Rosenstein and Wyatt (1990),

²⁵Decision management refers to initiation and implementation of decisions whilst decision control refers to ratification and monitoring of those management decisions.

who find positive share price reactions to the appointment of outside directors. Further, Boeker and Goodstein (1993) report that strong insider presence significantly influences, favourably, CEO replacement decisions. The recent tussle at the UK publishing conglomerate Emap between executive and non-executive directors best exemplifies the importance of the non-executive directors' role (Financial Times, November, 1996). In this case the non-executive directors disagree with other Emap directors on introducing a 75% rule which permits 75% of Emap's directors to remove a director from the board.

However, Mallette and Fowler (1992) observe empirically that the proportion of outside directors has no bearing on the adoption of poison pills. Poison pills are antitakeover mechanisms erected by management for the purpose of inflicting financial pain on bidders making a takeover bid for the firm (see Sudarsanam, 1995a, Chapter 12). Poison pills therefore act as a shield against hostile takeovers leading to enhancement of managerial entrenchment. Hostile takeovers are generally considered to be a good thing for the target firm. The threat of hostile takeovers and the potential loss of corporate control over the firm have the effect of putting incumbent target management 'on their toes'. However, Hermalin and Weisbach (1992) and Shivdasani (1993) are unable to document any systematic relation between outside directors, firm performance and the probability of hostile takeovers.

There are impediments to effective monitoring by non-executive directors. Baysinger and Hoskisson (1990) cite information asymmetry whereby outside

directors do not possess all the information that executive directors have. Moreover, the insiders may have packed the board with outside directors who are beholden to them in some way and therefore subservient.

In the context of declining firms, their performance decline may have been caused by managerial entrenchment, and weak governance structure may have contributed to this entrenchment. Turnaround may, therefore, demand managerial restructuring with the top management being replaced. Whether such managerial restructuring can be carried out depends upon the independence and strength of the board and the power of block shareholders and lenders.

4.2.4 Summary of agency monitoring mechanisms and their impact on corporate restructuring

Agency-control mechanisms, in general, contribute to efficient monitoring of managerial actions (eg Ofek, 1993; Gilson, 1989; Lang et. al., 1995). Table 4.1 summarises the foregoing literature review on agency motivation-strategy choice behaviour and highlights the incentives to monitor and the empirical findings on the impact of agency monitors on corporate restructuring.

Lender monitoring is motivated by the desire of lenders to reduce their risk of losses and maintain their reputational capital as good lenders. Extant empirical evidence on its effectiveness is largely US-based except for Lasfer et al.'s (1996) UK study of the role of lender monitoring and their impact on shareholder wealth of divestment announcements by samples of financially healthy and distressed firms.

Table 4.1 Agency monitoring incentives and corporate restructuring

Agency control device	Variable	Incentives to monitor firm and trigger corporate restructuring	Results from prior decline-related research
Lender monitoring	Leverage	Risk of financial loss and reputational capital as a good lender.	US: Positive relation between gearing and: financial restructuring and operational restructuring (Ofek, 1993), managerial restructuring (Gilson, 1989), and divestment (Lang et al, 1995). UK: Positive relation between debt financing and shareholder wealth impact of divestment (Lasfer et al, 1996).
Bank debt	Risk of financial loss and reputational capital as a good banker	Risk of financial loss and reputational capital as a good banker	US: Positive relation between bank debt and top management removal (Gilson, 1989). UK: Not previously examined.
Short term debt	Risk of default, reputational capital as a good lender, and frequent assessment of borrower on debt renewal.	Risk of default, reputational capital as a good lender, and frequent assessment of borrower on debt renewal.	US: Positive relationship between short term leverage and operational and managerial restructuring (Ofek, 1993). UK: Not previously examined.
Unsecured debt	Risk of financial loss, as loan is unprotected by any security.	Risk of financial loss, as loan is unprotected by any security.	Not previously examined.

Table 4.1 Agency monitoring incentives and corporate restructuring (contd.)

Agency control device	Variable	Incentives to monitor firm and trigger corporate restructuring	Results from prior decline-related research
Managerial incentive alignment	Managerial shareholding	Alignment of interests to those of shareholders. To prevent control passing to lenders.	US: Positive/negative relation between managerial shareholding and asset sales/managerial restructuring strategies (Ofek, 1993). UK: Not previously examined
Block shareholder monitoring	Institutional blockholding	Protect investment value and firm control.	US: Negative relation is found between institutional shareholding and most corporate restructuring actions (Ofek, 1993). Positive relation between institutional share holding and corporate restructuring (Bethel and Liebeskind, 1993). UK: Not previously examined
	Non-institutional blockholding	Protect investment value and firm control.	US: No relation is found between block shareholding and corporate restructuring actions (Ofek, 1993). UK: Not previously examined
	Associated non-institutional blockholding	Little, as they are influenced or controlled by management.	Not previously examined.
	Unassociated non-institutional blockholding	Protect investment value and firm control.	Not previously examined.

Table 4.1 Agency monitoring incentives and corporate restructuring (contd.)

Agency control device	Variable	Incentives to monitor firm and trigger corporate restructuring	Results from prior decline-related research
Corporate governance (Board monitoring)	CEO duality	Board members' mutual monitoring is minimal when the board is dominated by a joint CEO/chairman.	Not previously examined.
	Non-executive Chairman	Reputational capital as professional corporate 'referee'	Not previously examined.
	Proportion of non-executive directors in the board.	Reputational capital as professional corporate 'referees'	Not previously examined.

The role of short term lenders is examined by Ofek (1993) and their presence is found to be positively related to operational and managerial restructuring. However, there is no similar study of UK firms. The role of unsecured lenders, who possess strong incentives to monitor managerial actions due to the unprotected nature of their lending, is yet unexplored.

Manager-shareholders' incentives are aligned to those of other shareholders as they possess high stakes in their own firms. Ofek (1993) finds managerial shareholding to favour asset sales but, unsurprisingly, to disfavour removing themselves.

However, no UK-based decline-related study has examined this relationship. Non-manager institutional block shareholders are primarily motivated to monitor manager's actions by virtue of their desire to protect their investments and maintain control over the firm. The evidence on institutional shareholders role in corporate restructuring is mixed as Ofek (1993) finds them disfavoured restructuring whilst Bethel and Liebeskind (1993) find them favouring it.

However, Ofek studies specifically poorly performing firms, and hence his results are more relevant to this research. In the case of non-institutional block shareholding no relation to restructuring strategies is found by Ofek. No study has separately examined the impact of associated and unassociated elements of non-institutional block shareholding on restructuring strategy choice, in a turnaround context. As for the UK, no study has examined the role of any of the shareholder types on restructuring strategy choice.

The role of board or governance structure on restructuring strategy choice has received little attention so far. When the Chairman is also the CEO, the governing board is practically controlled by the dominant dual role CEO. Similarly, when the board is chaired by a part-time non-executive Chairman, monitoring of management actions from the 'inside' may be weak, leading to potential managerial entrenchment. This is in spite of the motivation to protect the non-executive Chairman's reputational capital as a corporate referee. However, where the decision control function is adequately separated from the decision management function, as evidenced by a high proportion of outside directors in the board, reputational capital of these corporate referees is likely to promote intensive monitoring and hence necessary restructuring in the wake of the firm's performance decline.

4.3 Impact of agency control mechanisms on specific restructuring strategy choice

In the choice of restructuring strategies, the influences representing ownership, board composition and lenders may often be mutually reinforcing but at other times working at cross purposes. In other words, the monitoring roles of owners, governance and lenders may be complimentary, substitutory or contradictory. Lenders and outside directors may complement each other, say in forcing management changes in declining firms. However, high leverage and high lender influence for management change may substitute for the lack of pressure

from outside directors for the same action, where the proportion of outside directors in the board is low. An example of contradictory influence arises when lenders press for asset sales and rights issue to generate cash for the purpose of paying down debt. Lenders' preference, in this case, clearly contradicts owners' desire to avoid injecting fresh equity funds and their preference for lenders to increase or at least maintain their financial support.

The primary focus of this study is the impact of three broad categories of agency monitoring mechanisms - ownership, leverage and board composition - on the turnaround strategies of poorly performing firms. We examine the individual as well as the combined effects of the three mechanisms. Exploring the combined effects resulting from the complex *ex ante* interactions among the agency mechanisms requires a suitable empirical formulation. In this respect, we introduce the practical concept of stakeholder dominance to test for complex interactions, and argue that the impact on strategy choice rests, ultimately, on the relative bargaining powers of the different stakeholder groups.

In the following sections, we shall adopt a top down approach to exploring the impact of agency variables on restructuring strategy choice. First, we introduce the concept of stakeholder dominance and explore the interactive effects on strategy choice when the firms' decision making process is dominated by a single stakeholder. Next, we explore the combined impact of lenders, ownership and governance variables on specific strategy choice.

4.3.1 Effects of stakeholder dominance on specific strategy choice

Our discussion earlier has ignored the relative bargaining powers of the different stakeholder groups in declining firms when strategy choices are made. The choice of a strategy is likely to be decided by the relative strength and dominance of these stakeholders.

Dominance in the decision-making process by the various stakeholder groups is discussed below and summarised in Table 4.2. We develop the concept of stakeholder dominance to take into account the complex interactions between the various stakeholders or agency monitors indicated above. Five types of stakeholder dominance are examined- lender, manager-owner, blockholder, dual CEO and collective board dominance. Since this conceptual innovation is derived from the literature reviewed earlier, the related empirical evidence is not re-quoted here.

Specific strategies are classified, as far as practicable, into cash generative, cash depleting or cash preserving strategies. Divestment and equity issues are clearly cash generative actions. Debt restructuring often involves some element of new working capital which qualifies this strategy for discussion purposes as cash generative. Other strategies are therefore non-cash generative, except for dividend cut/omission which is cash preserving.

Table 4.2: Stakeholder dominance and specific restructuring strategy choice

Generic strategies	Specific strategies	Cash generative (+), cash depleting (-) or cash preserving (0)	Conflict of interest among stake holders	Lender	Manager-owner and dual CEO	Blockholders	Collective board
Predicted choice: Favoured (+) or resisted (-)							
Operational	Cost cutting, layoff, closure and integration of business	-	Low	+	-	+	+
Asset	Divestment	+	High	+	-	-	+
	Investment	-	High	-	+	-	+
Managerial	Replace top management	-	High	+	-	+	+
Financial	Equity:						
	Dividend cut/omission	0	High	+	-	-	+
	Equity issue	+	High	+	-	-	+
	Debt: Restructure debt	+	High	-/+	-	+	+
Combined	Cash generative	+	High	+	-	-	+

Lender dominance

Where a firm is highly leveraged and has suffered a severe decline, lenders²⁶ are deemed dominant in influencing the firm's policy decision making machinery. In the history of the 1986 Insolvency Act, no listed firms put into administration²⁷ or receivership has emerged intact without dramatic change in ownership and/or business structure (Financial Times, 3/10/1993).

In the majority of cases, insolvent firms are either sold as going-concerns or piecemeal. Recent work by Jensen (1989 a,b) suggests that leverage is an important determinant of how decision rights are allocated among claimholders. Therefore, when a firm is severely distressed, with equity shareholders occupying a very low position in the repayment queue, lenders have the ultimate say and influence on the firm's restructuring choice.

Lenders would generally prefer short-term cash generative strategies to facilitate debt repayment. They would prefer cash to be generated by the firm via equity issues and asset divestments to facilitate repayment rather than accept a deferment of repayment through debt restructuring. However, since highly leveraged firms, by construct, are bound to need more debt restructuring than lowly leveraged ones, lenders may, indirectly, have a positive relationship with

²⁶ In the UK, secured creditors are frequently blamed for pulling the plug on firms too soon. The appointment of a receiver by secured lenders, or an administrative receiver when a floating charge is held, effectively 'terminates' the distressed firm, as few firms emerge intact without dramatic change in ownership and/or business structure from the exercise (Financial Times, March 10, 1993).

²⁷With the exception of Chancery, the small financial services company which was successfully reconstructed in 1991.

debt restructuring.

Also, lenders may frequently insist on removal of top managers and freeze on investments as a condition for continuing financial support. Removal of top managers poses a serious conflict with managers' interest, but if the firm's financial position is dire, managers have little power to avoid displacement even if they hold a high equity share holding.

Asset sales may pose a conflict of interest with block shareholders as they deem the sale of assets to extinguish the option value attached to assets sold (see Section 4.2). However, lenders' conflict with blockholders intensifies over the question of equity issues.

Blockholders would only be willing to risk 'good money' in pursuit of recovery if lenders are shouldering a part of the financial burden by restructuring their claim. However, in the final analysis, lender dominance prevails as their continued support is key to the survival of the firm. Management may therefore be forced to implement cash generative actions such as asset sales and equity issues and refrain from cash consuming asset investment strategies.

Manager-owner dominance

If the firm's decision making process is not dominated by lenders, and managerial and manager-associated shareholdings are high, manager-owners are deemed to be entrenched and possess dominant influence. In the circumstance, entrenched managers are expected, in the least, to refrain from adopting

managerial restructuring strategies. Due to shareholders' dislike of equity issues (see e.g. Schipper and Smith, 1986) dominant managers, with their significant equity shareholding, would most likely avoid making such issues. Equally, they may resist dividend cuts/omissions which reduce their effective total income. The literature (e.g. Meeks and Whittington, 1975; Conyon and Clegg, 1994) suggests that entrenched managers favour large size as power and compensation are related to size. Consequently, dominant managers may refrain from downsizing their operations through operational restructuring or asset divestment and prefer increasing investment through acquisitions or capital expenditure. In other words, manager-owners are expected to disfavour cash generative asset sales and equity issues.

Likewise, dominant managers are likely to disfavour the 'final resort' strategy - debt restructuring - which is adopted only when all efforts to pay off (or buy out) creditors fail. In a debt restructuring exercise, lenders frequently insist on dealing with a credible management leading frequently to installation of a new management team (Gilson, 1989).

Blockholder dominance

Where neither lenders nor manager-owners are dominant, and unassociated blockholding is high, blockholders may dominate the firm's decision making process. Operational restructuring which is the least controversial of all strategies is expected to be favoured by dominant blockholders. Extant literature (e.g.

Schipper and Smith, 1986; Asquith and Mullins, 1986) indicating shareholders' dislike for equity-based strategies such as dividend cut and omission, and equity issue, would mean that they are shunned by dominant blockholders. As discussed above, shareholders also may shun asset sales as they extinguish the option value attached to those assets. Following from dominant shareholders' dislike of cash generative actions (equity issues and asset sales), we can expect them to disfavour investments which necessitate such cash generative actions.

Dominant blockholders are expected to favour debt restructuring as lenders frequently provide additional working capital, forgive loans or interests or make other concessions, though reluctantly, in the hope of realising higher debt repayment when the firm is eventually turned around. Similarly, dominant blockholders who possess significant influence over management, are expected to initiate top management replacement.

In summary, blockholder dominance is expected to be positively associated with operational, managerial and debt restructuring but negatively associated with all other strategies.

Dual CEO and collective board dominance

When the firm is not lender, manager-owner or blockholder dominated, corporate control is expected to lie with the board of directors. However, where the board is chaired by a dual CEO, the dual CEO is expected to dominate the

board and hence the firm's decision making process²⁸. CEO board dominance is expected to favour strategies akin to manager-owner dominance firms i.e. shun managerial restructuring, prefer investments, and avoid operational restructuring and cash generative actions.

When the firm is not lender, manager-owner, blockholder or CEO dominated, corporate control is expected to lie 'collectively' with the board of directors. Since the collective interests of all stakeholders are in the aversion of a crisis and recovery, collective board dominance is expected to be positively associated with all restructuring strategies.

4.3.2 Combined impact of stakeholders on specific strategy choice.

Having discussed the dominant effects on managerial strategy choice when a stakeholder dominates the firm's decision making process, we extend the arguments made above to explore the combined impact of stakeholders - lenders, ownership and governance, on strategy choice. Again, based on synthesising the extant theory and the conceptual arguments made earlier in section 4.2 and 4.3.1, Table 4.3 presents the predicted individual impact of lenders, ownership and governance mechanisms on specific strategy choice. The similarity between Tables 4.2 and 4.3 is to be expected since stakeholders such as lenders, managers and blockholders impose the same demands on declining firms regardless of whether they are in a dominant position or not.

²⁸Although a non-executive Chairmen structure may lead to potentially weak governance and CEO entrenchment (see Section 4.2.3), we do not consider the CEO is entrenched enough, in this structure, as to dominate the firm's decision-making process.

Table 4.3: Impact of lenders, ownership and governance on restructuring strategy choice

The table shows the predicted impact of lenders, ownership and governance variables on restructuring strategy choice. For definitions of strategies, refer to Sections 3.2 to 3.5. Inside shareholding refer to manager and manager-associated ownership, and outside shareholding refers to all blockholding unassociated with management. Cash generative strategy comprises divestment and equity issue. The signs +, -, 0 denote favoured, resisted and neutral respectively.

Specific strategies	Lender	Inside shareholders, Chairman cum CEO and Non-executive Chairman	Outside shareholders	Outside directors
	Predicted impact			
Operational	+	-	-/+	+
Asset:				
Divestment	+	-	-	+
Investment	-	+	-	+
Managerial	+	-	+	+
Financial:				
Dividend cut/omission	+	-	-	+
Equity issue	+	-	-	+
Debt restructuring	-	-/+	+	+
Cash generative	+	-	-	+

Therefore, lenders are expected to prefer cash generating strategies such as divestments and equity issues and resist investments, both capital expenditure and acquisitions. This behaviour, and the theory and conceptual arguments in its support, are similar to those when lenders become the firm's dominant stakeholder (see Lender dominance in Section 4.3.1).

Earlier, we considered high inside shareholders, comprising manager and manager-associated ownership, and dual-CEOs (Chairman cum CEO) to lead to managerial entrenchment and dominance (when the firm is not lender-dominated, see Section 4.3.1).

Likewise, inside shareholders and dual-CEO are expected to prefer asset investment and resist any other restructuring strategies. As discussed in section 4.2.3, a non-executive Chairman structure can lead to CEOs wielding excessive executive control over the firm., and that such a weak governance structure is expected to lead potentially to CEO entrenchment and its accompanying malaise.

Therefore, we expect non-executive Chairmen to exhibit behaviour similar to that of entrenched managers i.e. prefer asset investment and resist any other restructuring strategies.

Similarly, we expect unassociated blockholders to display preferences akin to the situation whereby blockholders dominate the firm's decision making process. They are, therefore, expected to favour operational, managerial and debt restructuring but resist all other strategies.

Finally, outside directors are expected to act in the collective interests of

all stakeholders. As such, they are expected to favour all restructuring strategies instrumental to recovery from performance decline.

No study to date has examined the relationships between agency monitors' motivations and restructuring strategy choice in a comprehensive manner. Although Ofek (1993) finds that different agency variables are associated with different restructuring strategies, his approach lacks a robust theoretical underpinning. More importantly, Ofek does not examine the relative dominance of stakeholders in shaping restructuring strategy choices. He also does not examine the impact of governance variables and control for the impact of external environmental factors. This research attempts to fill the empirical gap by exploring the impact of a comprehensive range of agency monitoring mechanisms on specific strategy choice and controlling for other internal and external factors.

4.4 Contextual factors

The empirical literature (e.g. Schendel et. al, 1976; Robbins and Pearce II, 1992, 1993) suggests that turnaround strategy choices are also dictated by many non-agency monitoring factors. These additional variables - causes of decline, severity of decline, firm size, industry and economic condition are included as control variables in this research.

4.4.1 Causes of performance decline

Schendel et al, (1976) suggest turnaround response to be dependent on the

cause of performance decline. They argue that if the cause of decline is ineffective strategy or inefficient implementation of strategy, the turnaround strategy should appropriately be strategic change (long term asset restructuring) or improvement in strategy implementation (managerial and operational restructuring). Hambrick and Schecter (1983) empirically find internal or efficiency causes to require operating turnarounds while strategic problems require asset/strategic turnaround measures. Also, Robbins and Pearce II (1992) find that firms citing internal factors as the primary cause of performance decline are more likely to retrench (cost reduction and asset reduction) than those that attribute external factors to performance decline. Examples of internal causes of performance decline are poor financial controls and bad investments such as failed new product launches or acquisitions. Economic recession, unfavourable exchange or interest rates and international competition are some examples of external causes of performance decline cited by management (John, Lang and Netter, 1992).

4.4.2 Severity of decline

Hofer (1980) introduces the notion that the severity of the turnaround situation in terms of how close the troubled firm is to financial insolvency affects its response to performance decline. When a firm experiences severe decline, cash generation strategies e.g. asset reduction and equity issues, supported by tight financial control take first priority (Slatter, 1984). They generate greater and quicker cash inflows than cost reduction and revenue generation strategies. Asset

investment in this context is feasible only after the 'survival' of the firm is assured. In contrast, firms with less severe decline have the flexibility of growing out of performance decline via asset investment. Firms in severe distress, as measured by below sample mean Z-score, are found, empirically, to require asset reductions in additions to cost reduction strategies to achieve turnarounds (Robbins and Pearce II, 1992).

4.4.3 Firm size

Firm size is suggested as affecting firm choice of restructuring actions (Ofek, 1993). For example, small firms tend to be less diversified than large firms and therefore have fewer opportunities to raise cash via selling assets. Compared to single product/market firms, a highly diversified firm can also reconfigure its asset portfolio to recover from performance decline. Asset reduction e.g. divestment of subsidiaries is normally feasible only for the diversified firms. Empirically, Robbins and Pearce II (1992) find large firms pursue 'entrepreneurial retrenchment' or cost and asset reduction strategies more readily than small firms. This finding is consistent with Schleifer and Vishny's (1992) contention that large firms with diversified asset portfolios have potentially greater asset liquidity than small firms.

4.4.4 Industry condition

The industry in which the firm operates affects the choice of strategies open

to it. Where a firm is performing poorly against a background of growth in its industry, the choice of say asset sales is more feasible and attractive than when the firm's industry is at the bottom of its cycle²⁹ (Schleifer and Vishny, 1992). Attempting to start a turnaround during an industry downturn is very difficult (Slatter, 1984). There are two strategic options open to a firm attempting to recover from performance decline during an industry downturn - restructure and remain in the same industry or divest and enter a growth industry. Both measures require investments. To compete in the same depressed industry, poor performing firms need to raise productivity and efficiency in order to improve margins and profits. This probably necessitates investment in new plants and machinery. Alternatively, poor performing firms can sell out businesses facing industry downturns and buy into businesses in growth industries.

4.4.5 Economic condition

Similarly, the stage of the macro-economic cycle can also condition the availability and choice of restructuring strategies. For instance, economic condition has a marked impact on the feasibility of cash generating actions. Asset sales, equity issues and even debt raising is a more feasible proposition in boom times than in recessionary periods. In the last recession, bank-credit squeeze and interest rates at 15%, virtually ruled out debt issue for most except the strongest companies. Simultaneously, the depressed state of the stock market effectively

²⁹When all firms in the industry are likely to experience a downturn.

barred many firms from raising rescue-equity from investors.

4.5 Summary of determinants of restructuring strategy choice

Firms that experience performance decline may choose a variety of alternative methods of restructuring themselves to restore their financial health. However, any restructuring strategy has different, and often conflicting, welfare implications for the different stakeholders in firms - shareholders, lenders and managers. Within the agency model of the firm the strategic choices made by managers may benefit one group of stakeholders at the expense of the other groups. However, managerial choices are also constrained by the agency monitoring embodied in the firms. Agency monitoring may be embodied in the rights of lenders, the power and influence of large block shareholders or in the oversight function and independence of the board of directors. Also, several non-agency variables, internal and external factors, have significant impact on strategy choice. The choice of recovery strategies is, therefore, determined by the complex interplay of the ownership structure, corporate governance, lender monitoring of the firms in decline and certain control factors. Consequently, we formulate a conceptual framework to capture all these influences.

However, the conceptual framework does not relate every agency or control variable to every restructuring strategy. To this extent some of the empirical work in this research is exploratory, but some of it is based on existing theories. In this respect, the thesis not only contributes UK evidence to confirm existing theories

but also provides new empirical evidence to substantiate new concepts such as the role of governance variables and stakeholder dominance on managers' restructuring strategy choice.

Having reviewed the determinants of restructuring strategy choice, we shall examine in the next chapter, the theory and empirical evidence on the effectiveness of these strategies.

Appendix 4.1 : Review of decline-related studies: Causes of decline and turnaround strategies
Please refer to Appendices 2.1 and 3.1 for details of decline definition, sample, period, and sample size.

Studies	Causes of decline	Strategy examined	Variables explaining choice of strategy (NA is not applicable)
Argenti (1976)	Internal - accounting information, management, unresponsive to change, big project, gearing, and over-trading. External - business hazards.	Operational, asset, managerial and financial.	NA (no description or analysis of such variables)
Carrington and Aurelio (1976)	Internal - overexpansion and under capitalization. External - recession	Operational and debt.	NA
Hamermesh (1976,77)	Internal - lack of control and failed mergers. External - recession and competition.	Managerial and operational.	NA
Schendel, Patton and Riggs (1976)	Internal - management problems, higher costs, marketing problems and strikes. External - increased competition and declining demand.	Managerial, operational and asset.	Cause of decline.
Biteman (1979)	Internal - death of founder, management errors, over-expansion External - decline of traditional market.	Managerial, operational and asset.	Internal or external condition and turnaround manager's external power bases.
Graham and Richards (1979)	External - industry decline	Managerial and asset.	Degree of diversification, and pre-distress return on assets.

Appendix 4.1 : Review of decline-related studies: Causes of decline and turnaround strategies (Contd.)

Studies	Causes of decline	Strategies examined	Variables explaining choice of strategy
Hofer (1980)		Managerial, operational and asset.	Cause and severity of decline i.e. operating and strategic health of firm, and external economic condition.
O'Neill (1981)	Internal -bad loan management.	Managerial, operational, asset and debt.	NA
Bibeault (1982)	Internal - poor management. External - economic downturn, competition, social change and technology.	Managerial, operational and asset.	Cause of decline.
Hambrick and Schechter (1983)	Not examined.	Operational and asset.	Plant capacity utilisation and market share.
Ramanujam (1984)	External -environmental volatility.	Operational and asset.	Industry context -growth rate. Organisational context- size.
Slatter (1984)	Internal- lack of financial control, high cost structure, inadequate management, marketing problems, big projects /acquisitions that failed, high leverage, and overtrading. External - competition, changes in demand, and adverse commodity price movements.	Managerial, operational, asset and financial.	Cause and severity of decline, attitudes of stakeholders, industry, and firm's cost-price structure.

Appendix 4.1 : Review of decline-related studies: Causes of decline and turnaround strategies (Contd.)

Studies	Causes of decline	Strategies examined	Variables explaining choice of strategy
Melin (1985)	Internal- lack of economies of scale and high cost base. External- saturated demand, technological change and increased competition.	Managerial, operational and asset.	Degree of decentralisation in organisation structure.
O'Neill (1986)	Internal - administrative. External - cyclical, competitive and political.	Managerial, operational and asset.	Cause of decline, industry concentration, product life cycle and competitive position.
Pant (1986)	Not examined.	Operational and asset.	Firm sales, capital intensity, and leverage.
Grinyer, Mayes and Mckierman.(1988)	Internal - lack of marketing/sales effort, poor product quality, poor management, inadequate financial control, poor organisation, high cost structure, bad acquisitions and project failures. External - adverse changes in total market demand, and falling revenue due to competitive pressure.	Managerial, operational, asset and financial.	Causes of decline and triggers of change. Source of triggers: intervention from external bodies, change of ownership, new CEO or recognition of problem by management.

Appendix 4.1 : Review of decline-related studies: Causes of decline and turnaround strategies (Contd.)

Studies	Causes of decline	Strategies examined	Variables explaining choice of strategy
Gilson (1989)	Not examined	Managerial	Bank debt, Tobin's Q, high intangible assets.
Bonnier and Bruner (1989)	Not examined	Managerial	Not examined.
John, Lang and Netter (1992)	Internal - e.g. failed acquisition, over-diversification, high costs, too much debt and poor product mix. External - economic condition and competition.	Managerial, operational, asset and financial.	Not examined (survey).
Robbins and Pearce II (1992)	Internal and external causes quoted by the firm.	Operational and asset.	Internal cause of decline and severity of distress (Z score),
Brown, James and Mooradian (1993)	Not examined.	Debt	Leverage, private and public debt.
Gilson and Vetsuypens (1993)	Not examined.	Managerial	Change in shareholder wealth i.e. Annual change in the market value of the firms.
Ofek (1993)	Not examined.	Managerial, operational, asset and financial.	Leverage, debt and equity, ownership, size
Robbins and Pearce II (1993)	Not examined.	Operational and asset.	Size of firm and severity of decline.

Appendix 4.1 : Review of decline-related studies: Causes of decline and turnaround strategies (Contd.)

Studies	Causes of decline	Strategies examined	Variables explaining choice of strategy
Brown et al.(1994)	Not examined.	Asset	Debt ownership, management shareholding.
Lang, Poulsen and Stulz (1995)	Not examined.	Asset	Leverage, firm performance, use of sale proceeds
Lasfer, Sudarsanam and Taffler.(1996)	Not examined.	Asset	Financial health (bankruptcy risk), leverage, and size

Chapter 5. EFFECTIVENESS OF RESTRUCTURING STRATEGIES AND CORPORATE TURNAROUND: EMPIRICAL EVIDENCE

5.1 Introduction

The comprehensive restructuring framework discussed in Chapter 4 represents the key turnaround 'gestalt' found in the literature. However, prior strategy research, with a few exceptions (e.g. Grinyer, Mayes and Mckiernan, 1988), has over-emphasised turnaround strategies and paid scant attention to their implementation. Moreover, the restructuring strategies prescribed in the turnaround literature are based largely on small samples or case-study analyses. The general applicability of these generic and specific strategies has not yet been tested on a large, multi-industry sample. In other words, no large scale cross-sectional analysis has been conducted to test the general effectiveness of these turnaround strategies.

Corporate downward spiral to failure is attributed by past researchers (e.g. Schendel et al., 1976; Hofer, 1980; Hambrick and Schechter, 1983; Hoffman, 1989; Weitzel and Jonsson, 1989; Barker and Mone, 1993) to managerial inaction, poor timing, lack of intensity and poor implementation of turnaround strategies. Again, empirical evidence, based on large scale analysis, for the validity of these factors, is limited.

We aim to fill the empirical gap and learn important lessons from those

firms that have suffered performance decline but manage to recover and avoid long term distress. Vital empirical questions remain to be answered. Do firms that recover from performance decline adopt different restructuring strategies from those that decline further into severe distress, and which of these strategies are effective in contributing to corporate turnaround?

In this chapter, we review measures of strategy effectiveness proposed in the strategic management literature, highlight their deficiencies and provide improved measure. We review the recent finance literature to support the preferred measure. Finally, we discuss the turnaround process - the choice of strategy, its timing and intensity and the role of implementation in ensuring effectiveness of a turnaround strategy.

5.2 Deficiencies in existing measures of turnaround strategy effectiveness

Extant turnaround research (e.g. Schendel and Patton (1976) ; Hambrick and Schechter, 1983; Robbins and Pearce II (1992, 1993)) has invariably used accounting ratios to measure the success of turnaround strategies. These studies use a variety of accounting ratios to proxy for costs and asset reduction. The most common approach has been to analyse change in these proxies between two points in time - a base year (typically the worst year financially during the downturn) and the year in which firm performance improves to a target level or after a number of years post-decline. They conclude, from greater improvements for successful than for failed turnarounds that costs reduction and asset reduction strategies are

effective recovery strategies. For example, the observation that total costs (overheads and interest) are lower in successful than in failed turnaround firms leads prior researchers to conclude that costs reduction strategy is effective. Likewise, a higher net reduction in assets, both long and short term, in successful turnarounds is taken to indicate that asset reduction strategies are effective (e.g. Pearce and Robbins II, 1992, 1993).

Two common flaws may be identified in these studies.

1. Strategy proxy is part of the turnaround measure

The significant association between strategies and turnaround in performance is a definitional characteristic of these studies, as the ratios used to proxy for strategies also form part of the performance measure. For example, the use of costs reduction proxies such as reduction in total costs to relate to improvements in return on sales (ROS) - which use sales less costs as the numerator - cause the high association between reduction in total costs and turnaround in ROS to be high by construct. Similarly, the strong association between reduction in total assets and turnaround in return on investments (ROI) may be by construct as total asset is the denominator of ROI.

2. Proxies measure the end result of a strategy and not the strategy itself.

The proxies for strategies under examination e.g. lower costs of sale for cost reduction, may be brought about by various specific strategies such as operational restructuring, asset sales, investment in new plant and machinery or

acquisition of new businesses, or financial restructuring which gives rise to lower interests cost. In other words, the proxies merely measure the end result of a strategy or strategies and not the strategy itself.

Due to the deficiencies in strategy effectiveness measures used in extant strategic management literature, we turn our search to the finance literature, for a better approach. In the next section, we provide the rationale for our choice of effectiveness measures and back up our choice with a discussion of the relevant finance literature.

5.3 Strategy effectiveness measures used in this research

The true effect of a specific strategy and its impact on corporate turnaround is not easily susceptible to direct measurement. This difficulty stems from three issues. Firstly, strategies such as top management replacement have only an indirect impact on financial performance. Secondly, the length of time required for the effect of a strategy to show through in the firm's financial performance is indeterminable. Thirdly, the overlapping and joint effects of complementary strategies confound the effects of individual strategies.

However, a reasonably robust method for measuring the effectiveness of a strategy, indirectly, lies in capturing the stock market's reaction to its announcement. Using standard event study methodology to measure the shareholder wealth impact of strategy announcement, we can obtain a fairly reliable assessment of the effectiveness of that strategy, from the perspective of

the stock market.

Admittedly, shareholder wealth impact as a measure of strategy effectiveness equally suffers from one of the methodological flaws discussed earlier in Section 5.2. Specifically, since turnaround, in the poor performing sample of this research, is measured by recovery in stock returns ranking to pre-decline levels, total shareholder wealth impact from strategy announcements must be inherently more positive in recovery than non-recovery firms. Although the total shareholder wealth impact is more positive in recovery than non-recovery ones, the question remains ‘which strategies do recovery and non-recovery firms execute equally well’ and ‘which strategies do recovery firms execute better than their non-recovery counterparts? Furthermore, the use of shareholder wealth impact of strategy announcement to measure effectiveness clearly overcomes the other methodological flaw identified in the strategic management literature (see Section 5.2). In other words, the stock market captures immediately and directly the anticipated effects of a specific strategy and it is not a proxy measure for strategy.

We also employ an alternative but direct method for examining strategy effectiveness. This is based on testing the association between restructuring strategy and the extent of corporate recovery from performance decline. If a restructuring strategy is effective, it will register a strong positive association with recovery. Likewise, an ineffective strategy will result in a negative relation with recovery.

5.4 Strategy effectiveness: Shareholder wealth impact of strategy announcement

The following sections review the literature for empirical evidence on stock markets' assessment of various restructuring strategies. Most of these studies emanate from the finance literature and all except a handful is of a non-distress related nature. In fact, with the exception of Khanna and Poulsen (1995), no large sample study to date has empirically examined the effectiveness of restructuring strategies in a turnaround context.

As discussed earlier in Chapter 3, this research examines a comprehensive range of corporate recovery/restructuring strategies, synthesising both the strategic management and finance literature. It covers the generic strategies of managerial, operational, asset and financial restructuring.

5.4.1 Effectiveness of managerial restructuring

An inverse relation between the probability of management change and firm's stock performance is reported by Coughlan and Schmidt (1987) and Warner et al. (1988). Further, Keasey and Watson (1987), Gilson (1989, 1990), and Murphy and Zimmerman (1993) find significant top management changes in distressed firms. However, stock market's reaction to top management changes in distressed firms is mixed. Announcements of change in senior management in distressed firms are greeted positively (Bonnier and Bruner, 1989), negatively (Khanna and Poulsen, 1995) or neutrally (Weisbach, 1988) by the market.

Efficiency of internal and external corporate control mechanisms is suggested as a reason for positive excess returns whilst new but 'negative' information (eg. losses) is claimed to explain negative reactions to announcement of change in senior management. Internal and external corporate control mechanisms refer respectively to the internal governance structure (see Section 4.2.3) and external market for corporate control i.e. takeovers.

Others argue that the distinction between internal and external replacement of top managers is important. In the case of internal replacement, the internally promoted manager, who invariably shares a part of the blame for the firm's predicament, is seen to lack credibility. Indeed significant positive (negative) excess returns, based on the market model, are found to be associated with external (internal) replacement announcements (e.g. Worrell et. al, 1993). However, Khanna and Poulsen (1995), in their study of firms that subsequently file for Chapter 11 bankruptcy protection and a control sample of healthy firms, find both internal and external replacements in Chapter 11 firms to be greeted negatively but insignificantly by the market. They argue that the market does not place the blame on managers as the market does not perceive internal replacement as a continuation of the status quo and view it differently from an external replacement.

Although the impact of managerial restructuring on shareholder wealth has been widely examined in the financial economics literature, little is found in the strategic management literature, and virtually no UK-based large sample study in

either literature has examined managerial restructuring in a turnaround context.

5.4.2 Effectiveness of operational restructuring

Efficiency strategies entailing cost-cutting, productivity improvements and operating asset reductions have been found empirically to be associated with turnaround success (Schendel, Patton and Riggs, 1976; Hambrick and Schecter, 1983; O'Neill, 1986; Pearce II and Robbins, 1993; John, Lang and Netter, 1992). However, few large sample studies have specifically examined the impact on shareholder wealth of announcement of operational restructuring with the exception of Blackwell et. al (1990) and Khanna and Poulsen (1995). Blackwell et al. find plant closings to be associated with performance decline and that the market reacts negatively to such announcements. They interpret this as a negative information signal to the market. The negative information it conveys covers the cost of restructuring (and consumption of scarce cash resources) and the uncertainty of future firm earnings. However, Khanna and Poulsen (1995) find positive announcement effects on announcement of plant closings, layoffs, asset sales and downsizing in both Chapter 11 and healthy sample firms. Khanna and Poulsen's study, though, is not a suitable comparison to Blackwell et. al's study as their inclusion of asset sales, which are generally greeted positively (e.g. Lasfer et al, 1996) by the market, may mask the potentially negative effects of operational restructuring announcements (as documented by Blackwell et. al., 1990).

In practice, UK firms appear to lag behind their US counterparts in terms

of announcing operational restructuring as a separate event. Most often, operational restructuring is announced at the time of announcing financial results as it generally entails the provision of huge restructuring costs³⁰. As a result, event-study analysis of operational restructuring alone is not possible.

5.4.3 Effectiveness of asset restructuring

5.4.3.1 Asset divestment

Lasfer, Sudarsanam and Taffler (1996) empirically find asset sales by financially distressed firms to be associated with positive excess returns on announcements. Similar results are reported by Brown et al.(1994), Lang et al.(1995) and others. Arguments on the sources of such value creation though are less straightforward. Brown et al.(1994) argue that sales where proceeds are used to pay down debts extinguish the option value of assets and effectively transfer wealth from stockholders to bondholders. They argue that such sales should therefore extract lower positive response from the market than when the funds are retained. In contrast, Lang et al.(1995) argue that retention of funds raised from asset sales by poorly performing firms is bad news as such a retention potentially suffers from the agency costs of managerial discretion by swelling free cash flow. Consequently, sales where proceeds are used to pay down debts should attract higher positive returns on announcement.

³⁰This conclusion is based on a thorough review of Extel Financial News Summary (book) and Extel Company Research (CD-ROM), both covering company press releases to the Quotations Department of the London International Stock Exchange.

5.4.3.2 Asset investment

An entrepreneurial/strategic i.e. investment, approach to recovery is suggested to be instrumental to turnaround success (Schendel et al, 1976; Hofer, 1980). Although numerous large sample studies have empirically examined the benefits of asset divestments, no study has yet examined the importance of asset investments to turnaround firms except for Khanna and Poulsen (1995). In a study of firms in Chapter 11 and a control sample of healthy firms, Khanna and Poulsen find acquisition and expansion announcements to be associated with negative but insignificant returns for Chapter 11 firms but positive and significant returns for healthy firms. They attribute this as evidence that managers of Chapter 11 firms make significantly worse decisions than healthy control firms. As internal capital expenditure is seldom announced as a separate event, in the UK, only the shareholder wealth impact of acquisition announcements will be examined in this research.

5.4.4 Effectiveness of financial restructuring

5.4.4.1 Dividend cut/omission

DeAngelo and DeAngelo (1990) and John et al. (1992) empirically find large firms respond to financial distress with rapid and aggressive dividend reductions. Overall, extant studies reveal significant negative reactions to announcement of dividend cuts or omissions. These results lend support to the negative information content or cash flow signalling theory (Bajaj and Vijh, 1990; Christie, 1994; Denis, Denis and Sarin, 1994; Jensen and Johnson, 1995;

Michaelly, Thaler and Womack, 1995), dividend clientele theory (Denis, Denis and Sarin, 1994) and over-investment or agency costs theory (Lang and Litzenberger, 1989) of cuts or omissions in dividends. The cash flow signalling model predicts that dividend changes convey information about future cash flows i.e. a dividend increase (decrease) conveys favourable (unfavourable) information about the current and/or future cash flows of the firm. The dividend clientele hypothesis suggests that price reactions to dividend change announcement are influenced by the yield preference of the marginal investor in that firm's shares. Investors in low dividend yield firms, who have a relatively high aversion to dividends, will view an increase in dividends negatively, whilst investors in high-yield firms, who place a higher value on dividends, will react positively. The over-investment hypothesis is premised on the argument that dividend change may convey information regarding a firm's future investments. According to this hypothesis, a dividend increase by a firm with free cash flow problems will reduce the market's estimate of the amount of cash that will be wastefully invested, thereby increasing the firm's value. Similarly, a dividend decrease will signal that more negative NPV projects will be undertaken, causing a decrease in firm value.

In summary, extant evidence appears to suggest that the stock market takes a grave view of dividend cut/omission by declining firms. Among the three contending perspectives, the signalling theory appears to receive the widest support. In spite of stock market's disfavour of dividend cuts/omissions, cash-strapped firms may have little choice but to implement cut/omission in dividends to preserve scarce cash and avoid becoming insolvent.

5.4.4.2 Equity issues

The announcement effects of equity issues are largely negative. On average the market value of issuing firm drops significantly around the announcement of seasoned equity offerings (Smith, 1986; Asquith and Mullins, 1986; and Masulis and Korwar, 1986; Levis, 1994) although several studies on private equity offerings show overall positive announcement effect (e.g. Wruck, 1989). Cooney and Kalay (1993) attribute negative/positive effects to signalling effects of negative/positive net present value projects to be financed from the proceeds. Mikkelsen and Partch (1986) find rights issue used to repay debts have greater reduction in share prices than those that raise equity for capital expenditure purposes. They attribute the former to reduction in leverage and the latter to favourable signals. However, the only study on equity issue by distressed firms by Khanna and Poulsen (1995) reports negative but insignificant effects on announcement of equity issues.

5.4.4.3 Debt restructuring

Since debt restructuring frequently involves lenders sacrificing some of their rights, and the fact that successful debt restructuring alleviates bankruptcy risks and signals confidence by lenders in the firm's prospect, debt restructuring must be greeted positively by the market. On the other hand, lenders also frequently call on owners to share part of the financial burden of restructuring such as providing fresh capital via rights issues. However, debt restructuring effectively reduces the exercise price on the firm's call option i.e. equity.

Improvement in the option value of equity brought about by debt restructuring and alleviation of financial distress is expected to exceed costs of owner sacrifice.

No prior study, except for Khanna and Poulsen (1995), has specifically examined the impact of debt restructuring on stock returns in distressed firms. They examine a subset of debt restructuring i.e. debt-equity swaps, and find positive but insignificant abnormal returns from announcements of debt equity swaps by both Chapter 11, and a control sample of healthy, firms. One reason for the lack of significance may lie in the small number of cases examined (19 and 4 for Chapter 11 and control sample respectively), a problem caused by the rarity of formal debt restructuring in the US. This problem is even more acute in the UK than in the US, as there are far fewer formal or public debt restructuring in the UK.

5.4.5 Summary of perspectives on shareholder wealth impact of restructuring strategies

A summary of the shareholder wealth impact of restructuring strategies is shown in table 5.1 below. The effectiveness of managerial restructuring from the stock market's perspective is mixed. Operational restructuring is not only seen as costly, as it consumes cash in the short term, but its announcement may also signal to the market the firm's dire financial state. Consequently, the market marks down the firm's economic worth on such an announcement. In contrast, asset divestment is largely seen as a generic recovery strategy and is greeted positively by the market.

Table 5.1 Summary of perspectives on the impact of restructuring strategies

Strategies	Predicted impact on shareholder wealth and corporate recovery	Sign	Findings from prior decline-related studies
<i>Managerial restructuring</i>	Installation of new management may be a precondition of lenders' and owners' continued financial support. It renews managerial credibility in implementing strategies successfully.	+	US: Mixed impact (Bonnier and Bruner, 1989; Khanna and Poulsen, 1995; Weisbach, 1988). UK: Not previously examined.
<i>Operational restructuring</i>	Operational restructuring is costly, as it consumes scarce cash resources, and it may signal to the market the dire financial state of the firm.	-ve	US: Significantly negative in Blackwell et al. (1990). UK: Not previously examined.
<i>Asset restructuring</i>			
Divestment	Alleviation of financial distress from cash generated far outweighs the lost 'option value' on assets sold.	+ve	US: Significant in Brown et al.(1994), Lang et al. (1995). UK: Significant in Lasfer et al. (1996).
Investment	It consumes scarce cash resources during the turnaround period, suitable only when survival is assured. But it is key to the rejuvenation phase of corporate turnaround.	?	US: Insignificant in Khanna and Poulsen (1995). UK: Not previously examined

Table 5.1 Summary of perspectives on the impact of restructuring strategies (Contd.)

Strategies	Predicted impact on shareholder wealth and corporate recovery	Sign	Findings from prior decline-related studies
<i>Financial restructuring</i>			
Dividend cut/omission	Signals the bad state of firm's financial health, and 'painful' to shareholders.	-ve	US: Significant in Christie (1994) and Denis, Denis and Sarin (1994).. UK: Not previously examined.
Equity issue	Signals the bad state of firm's financial health, and 'painful' to shareholders.	-ve	US: Insignificant in Khanna and Poulsen (1995). UK: Not previously examined.
Debt restructuring	Lenders willingness to restructure their lending signals to the market that the firm is worth backing. Lenders agreement to restructure debt calls for sacrifices from both lender and owners. However, improvement in 'option value' of equity through alleviation of financial distress is expected to exceed costs of owner sacrifice.	+ve	US: Not previously examined. UK: Not previously examined.

Conversely, investments which invariably consume scarce cash resources in distressed firms are frowned upon by the market. The market reacts negatively to cut/omission in dividends as it signals to the market the bad state of the firm's financial health, and that is financially painful to shareholders³¹. On the same basis as dividend cut/omission, equity issue is greeted negatively by the market. Debt restructuring is expected to be greeted positively by the market as lenders' willingness to restructure their lending signals to the market that the firm is worth backing. Debt restructuring almost invariably involves lenders forgiving certain debts and/or interest and allowing extension of maturity terms (Gilson, 1990). On the other hand, debt-equity swaps frequently mean dilution of shareholders' ownership of the firm. However, as improvement in option value of equity following alleviation of financial distress is probably greater than the pain of dilution, debt restructuring is expected to be greeted positively by the market.

5.5 Strategy effectiveness: Impact of restructuring strategy and control variables on recovery from performance decline

As discussed in Chapter 2, in response to performance decline, management may take no action, a classic cause of failure (Schendel et al, 1976; Bibeault, 1982) or adopt various corporate restructuring strategies which may or may not be appropriate to recovery from performance decline. In consequence, performance

³¹The other perspectives apart from signalling e.g. dividend clientele and agency cost perspectives, support negative reaction to dividend cut/omission announcement.

decline firms can recover from their decline, deteriorate precipitously into distress or decline more gradually into failure or bankruptcy (see Figure 2.1).

Effectiveness of a particular strategy can therefore be tested via examining the impact of restructuring strategy on the extent of corporate recovery from performance decline. In other words, effectiveness or lack of effectiveness of a strategy can be represented by a positive or negative relation between adoption of that strategy and corporate recovery from performance decline.

The empirical literature (e.g. Grinyer et. al, 1988) also suggests suitability and effectiveness of turnaround strategy as dependent on certain internal and external factors. Severity of decline dictates both the pace of restructuring and effectiveness of particular actions. For example, asset investment or acquisitions may be unsuitable for more severely distressed firms as they consume scarce cash resources and as their immediate priority is survival and not growth.

Economic and industry conditions also may influence effectiveness of strategy. For example, where the industry as a whole is depressed, asset sales and divestments may not raise as much cash as otherwise (Schleifer and Vishny, 1992). Industry specific factors are found in the literature to be important explanatory factors in firm bankruptcy. For example, Lang and Stulz (1992) find the announcement of bankruptcy by one firm in an industry leads to a negative wealth impact on the remaining firms in the same industry. During an economic downturn, operational cost cutting actions would be effective but equity issues may not be appropriate as the stock market would be depressed. Size of the firm

is a proxy for both the flexibility and internal slack available to the declining firm. Also, certain strategies such as acquisitions, divestment, and debt restructuring are more appropriate for large than small firms. For example, a large firm may be able to negotiate debt restructuring more effectively.

Where the firm's performance decline has been caused by internal, firm-specific factors such as bad acquisitions or poor financial control, any restructuring has to reverse the firm specific causes. Again the effectiveness of restructuring will be dictated by the existence of internal causes of decline.

This alternative approach of measuring strategy effectiveness ie. examining the impact of restructuring strategy on the extent of corporate recovery, complements the first measure based on event-study described earlier. Whilst the first approach tests for the impact of individual strategy on shareholder wealth and hence measures the stock market perceived effectiveness of that strategy, the second approach tests for the impact of individual strategy, controlling for other strategies and contextual factors, on the eventual outcome or degree of recovery from performance decline.

5.6 Impact of implementation on effectiveness of restructuring strategies

Corporate turnaround is widely attributed to swift managerial actions to 'stop the bleeding' and 'nip the problem in the bud' (Bibeault, 1982). Corporate failure, on the other hand, is claimed to be caused by managerial inaction or inappropriate actions (Hoffman, 1989; Weitzel and Jonsson, 1989; Makridakis,

1991). However, to date no large sample empirical investigation has been conducted to verify this view. Given the large body of knowledge emanating from decades of turnaround research, it is inconceivable that managers of failed firms are not aware of restructuring remedies prescribed in the literature.

However, adoption of a turnaround strategy in itself is no guarantee of recovery. For a strategy to be effective in contributing to recovery, it has to be carried out swiftly and intensively (Slatter, 1984, pg. 129). For example, swift and deep, rather than a tardy and superficial, cost cutting is instrumental to efficiency improvements and eventual turnarounds.

However, we argue that swift and intensive actions may not necessarily guarantee success either. Ultimately, the success of any well chosen or excellent strategy lies in the quality of its implementation (Slatter, 1984, pg. 121). The most appropriate strategy may simply prove futile if it is implemented poorly. Indeed, poor implementation of turnaround strategies has been claimed to exacerbate decline (Cameron, Sutton and Whetten, 1988; Freeman and Cameron, 1993) Also, Barker III and Mone (1994), in their critique of Robbins and Pearce II's (1992) study, contend that how managers retrench could be more important than whether managers retrench at all. Similarly, Hoffman (1989) suggests that the difference between successful and failed turnarounds lies more in the strategy implementation process than in its content. Likewise, Stopford and Baden-Fuller (1990) find failing mature firms to take similar actions to firms that successfully rejuvenate. However, failing firms do only part of the task, and underplay the

importance of innovation in strategy and building organisations that are responsive from top to bottom (ie. implementation).

The overall effectiveness of a strategy can be measured by the stock market's reaction to announcement of its implementation. The wealth impact of strategy announcement captures the stock market's total assessment of the strategy, its timing, intensity and expected implementation success. As effectiveness of strategy implementation is incapable of direct measurement, it can be deduced indirectly from stock market reaction. Equally, strategy implementation can be inferred from tests of the association between restructuring strategies and corporate recovery from performance decline.

5.7 Summary

In this chapter, we review the strategic management and finance literatures for measures of effectiveness of restructuring strategies. We uncover flaws in the research methodologies used by strategy researchers, and decide on using measures found in the finance literature for this research. We discuss the finance and corporate restructuring literatures for effectiveness of restructuring strategies ranging from operational to asset, managerial and financial restructuring.

We aim to assess the effectiveness of strategies in two ways. One, we use stock market reaction to strategy announcement as an indirect measure of strategy effectiveness. Two, we test for strategy effectiveness through examining the association between adoption of a restructuring strategy and corporate recovery

from performance decline.

Extant research on effectiveness of restructuring strategies yields somewhat mixed results. Few have specifically examined the effectiveness of these strategies in a turnaround context. Existing studies also appear to emanate largely from the US. UK-based studies are few and far in between.

Corporate downward spiral to failure is attributed by past researchers to managerial inaction or poor timing, lack of intensity and poor implementation of restructuring strategies. Empirical evidence, based on large scale analysis, is however, limited. This research aims to fill these crucial empirical gaps.

Chapter 6 METHODOLOGY AND DATA: POOR PERFORMING AND DISTRESSED SAMPLES

6.1 Introduction

Ofek (1993), in the first study that empirically examines the impact of lenders and owners on restructuring strategy choice, employs a two-group logit discriminant model. The binary dependent variable represents firms that employ a specific strategy and those that do not.

However, Ofek's model is incomplete as it does not employ a comprehensive agency model and fails to control for the impact of the external environment on a firm's restructuring strategy choice. Specifically, Ofek omitted to include governance variables such as dual CEO, non-executive Chairman and the influence of outside directors.

A more serious flaw in Ofek's methodology lies in his analysis of only one year's strategy - the decline year. A one year analysis is hardly sufficient to capture the restructuring process. Focusing only on the decline year is also unsatisfactory since decline could start anywhere from the beginning to the end of that year.

Potentially, the cause and effect of decline can be mixed in the decline year. For instance, operational restructuring may well be the cause of stock market decline as it signals to the market the firm's dire financial health. Therefore, instead of restructuring following decline, it may well precede decline in stock market

returns.

However, as firms are theoretically argued (Jensen, 1989), and empirically shown (Ofek, 1993), to react speedily to decline, we decide to include the decline year in the first stage of our analysis i.e. in examining the determinants of strategy choice. As discussed later in this chapter, the examination of the determinants of strategy choice employs pre-decline year explanatory variables to examine decline and post-decline years' strategy choice. Hence, the problem of causality is not an issue at this stage of the analysis. Admittedly, not all the strategies we call restructuring strategies in the first year are strictly so, since some of them may well be decline inducing strategies. However, analysis of restructuring in the year of decline also enables us to compare our results with the only other study of this nature by Ofek (1993), who examines only the decline year strategies.

In view of the potential causality problem, we restrict our second stage analysis i.e. examining the effectiveness of strategies to post-decline year strategies. Intuitively, only post-decline strategies should be used to measure effectiveness of recovery measures from the point of decline i.e. end of the year of decline.

This research employs a comprehensive agency model and incorporates control variables vital to separate the effects of agency monitoring from other internal and external impact on managerial strategy choice (see Figure 4.1). Also, we examine three years of restructuring, including the year of decline.

In a turnaround context, no prior study has properly explored the

effectiveness of restructuring strategies in contributing to recovery from performance decline (see Section 5.2 and 5.3). In this research, we aim to test the effectiveness of strategies using standard event study methodology. We also test for the overall impact of strategies in bringing about a turnaround using logit and OLS regressions methodology. These methodologies are described below.

6.2 Methodology

6.2.1 Definition of poor performance and financial distress

Poor performance

Ofek (1993) defines performance decline in terms of the change in the annual stock return ranking of a firm among all the firms in the market from being in the top 67% in one year (the base year) to the bottom 10% in the following year (the decline year). This decline may range from a maximum of 100% (from the hundredth percentile to zero percentile) to a minimum of 23% (from the thirty third percentile to the tenth percentile). Ofek regards this steep fall in value as sufficient to trigger various restructuring actions by the poor performance firms.

We employ a definition broadly similar to Ofek's but arguably more stringent. A firm is defined as having experienced poor performance when it falls in annual stock return ranking of all firms in the London Stock Exchange to the bottom 20% in a year (the decline year) after having been in the top 50% in each of the two preceding years. In the decline year the maximum decline is 100% (from the hundredth percentile to zero percentile) and the minimum is 30% (from

the fiftieth percentile to the twentieth percentile). With this definition, in contrast to Ofek's, the fall in rank has to be much steeper for inclusion in our sample. Further, the fall is from a stable high performance. This condition avoids sampling companies whose performance decline is due to short term volatility of their share prices³².

Financial distress

Altman (1968) popularised the Z score as a measure of a firm's bankruptcy likelihood. In the UK, a popular Z score model used by banks and industrial firms is developed by Taffler (1984). With the Taffler model, firms with negative Z-scores are classified as potential failures, as their financial profiles resemble those of previously bankrupt firms.

The model, developed using linear discriminant techniques, takes the following form:

$$Z=c_0+c_1X_1+c_2X_2+c_3X_3+c_4X_4$$

where $x_1... x_4$ denote the financial ratios, and $c_1... c_4$ the coefficients.

³² The literature on stock price overreaction (De Bondt and Thaler, 1985) (see discussion in Sections 2.3.3. and 2.3.4). raises the concern that a stock return based measure of performance decline may merely represent a correction for the earlier overreaction. The condition of two consecutive years' good performance preceding the decline which we have applied in our sampling mitigates this problem. Further, anecdotal evidence suggests that stock market performance decline is not greeted with inertia and indifference by managers who smugly attribute such decline to the stock market whims such as overreaction. It appears that such performance decline is a cause for managerial concern and triggers remedial action including corporate restructuring. Indeed, Barker (1996) finds corporate managers to give great importance to City views.

There are two UK versions of the discriminant model employed in this research, made available by Syspas, a City financial analysis services firm. The first is used to analyse listed manufacturing and construction companies and has component ratios (with Mosteller-Wallace percentage contribution measures in brackets): profit before tax/current liabilities (53%), current assets/total liabilities (13%), current liabilities/total assets (18%) and no-credit interval³³ (16%). The second variant is used to rate listed retail enterprises and has ratios: cash flow/total liabilities (34%), debt/quick assets (10%), current liabilities/total assets (44%) and no-credit interval (12%).

Taffler (1995) tracks the performance of these models from their development. Overall, they have had better than 98% success rate in classifying subsequently bankrupt companies as potentially insolvent ($z < 0$) based on their last accounts prior to failure, and thus exhibit very high *ex ante* predictive ability.

For the purpose of our paper, a firm is in financial distress if it has a negative Z score for at least one year after a minimum of two consecutive years of positive Z scores. The purpose of imposing two year positive Z scores prior to decline is to capture the exact timing of decline.

6.2.2 Testing for the impact of stakeholder dominance

We divide our sample into two groups - one stakeholder dominated and the

³³This measures the number of days the company can continue to trade if it can no longer generate revenues (see Fadel and Parkinson, 1978, for discussion).

other non-dominated by that stakeholder. For each stakeholder group - lenders, manager-owners, dual-CEO, block shareholders and collective board of directors - we examine the likelihood of a given strategy being chosen. The difference in the proportions of sample firms in the dominated and non-dominated groups choosing a strategy is tested for statistical significance using the non-parametric Mann-Whitney Wilcoxon test statistic. Any significant difference reflects the influence of the dominant stakeholder.

6.2.3 Testing for the combined impact of agency and control variables on strategy choice

We employ the following model to examine the impact of agency monitoring and control variables on the choice of restructuring strategy.

$$CRS = f (\textit{Agency monitoring and control variables})$$

where

CRS = Corporate restructuring strategy

Agency monitoring variables= Leverage (bank, short, unsecured debt), ownership (managerial, institutional, associate and unassociated non-institutional shareholding) and governance (Chairman cum CEO, non-executive Chairman and proportion of outside directors).

**Control variables= Internal cause of decline, economic condition,
industry condition, firm size and severity of decline.**

6.2.4 Testing for strategy effectiveness: Event study of strategy announcements

Effectiveness of restructuring strategies is measured by the shareholder wealth impact of strategies around the announcement period and their long term contribution to effecting turnaround.

Shareholder wealth impact is estimated using the conventional event study methodology. A detailed description of this methodology is provided in Appendix 6.1. Risk adjusted returns are estimated from the market model using daily data (Brown and Warner, 1985). Similar to Khanna and Poulsen (1995), the estimation period is the Day-170 to Day-21 centred on the event day (Day 0). The estimated parameters are then used to calculate the abnormal returns over the announcement period, Days -5 to +5 relative to Day 0.

Estimation of the market model parameters is done with the thin trading adjustment method suggested by Dimson (1979). On the basis of maximum average sample beta, four leads and four lags are included in the OLS regression. Returns are logarithmic returns and the market index is the Financial Times All Share Index. To ensure robustness to model specification, abnormal returns are also measured using the market, size and mean adjusted models. Market adjusted returns are returns after deducting the returns to the FT-All Share Index for

comparable periods. Size-adjusted returns are returns after deducting returns to similar sized firms. To form size portfolios, we rank all companies listed on the London Stock Exchange (the Official List, the Unlisted Securities Market and Third Market -until 1990) covered by Datastream International, on their market capitalisation at 31st December, from 1986 to 1994. These companies are sorted into five deciles - the first decile forming the portfolio with the smallest 20% of listed firms, the second the next smallest 20% and so on. Portfolio log returns are then computed on an equally weighted basis for the following year. These portfolio returns thus form five size indices. At the end of each year the portfolios are rebalanced with the same procedure described earlier. Mean adjusted returns are returns after deducting the mean returns in the estimation period Day-170 to Day-21 centred on the event day (Day 0). Significance of daily average abnormal returns of all four models is then tested using the dependence method suggested by Brown and Warner (1985).

For the distressed sample, both distress and turnaround are measured in terms of accounting numbers from annual accounts. Hence, event study analysis is not feasible (see 6.3.1 below for a full discussion).

6.2.5 Testing for impact of strategy and control variables on corporate recovery

Next, logit and OLS regressions of recovery on restructuring strategies are run to test the effectiveness of restructuring strategies in achieving turnaround, two

years post-decline. Logit regression tests for the impact of explanatory variables on recovery versus non-recovery whilst OLS regression captures their impact on the extent of recovery. Non-strategy variables, discussed in section 5.5, are included in our regressions as control variables.

The model employed takes the following form:

Recovery = f (Restructuring strategies and control variables).

where

Recovery =

1. Return to top 50% in two-year cumulative stock returns ranking in the market (poor performing sample).
2. Return to positive Z-score (distressed sample).

both over two post-decline years.

Restructuring strategies = Operational, asset, managerial and financial restructuring strategies.

Control variables = Internal cause of decline, economic and industry condition, severity of decline and firm size.

6.3 Definitions of dependent variables

6.3.1 Testing for the combined impact of agency and control variables on strategy choice

We focus on whether distressed firms adopt a turnaround strategy independent of the size in monetary terms. Hence, each restructuring action is coded as a dummy variable in the regression model of strategy choice on agency and control variables in both the poorly performing and distressed samples.

The various restructuring actions declining firms choose are the dependent variables for the logit regressions. These actions fall into the four generic strategies - operational, asset, managerial and financial. Ofek (1993) distinguishes between actions resulting in short term cash inflow and those with no such cash inflow since cash generation to meet the firm's financial commitments may be necessary to alleviate financial distress and avoid default on them. Accordingly, we define combinations of restructuring strategies which generate cash and those which do not. For the distressed sample, strategies are based on accounting reports, as opposed to news reports for the poor performing sample. Hence, we discuss the dependent variables for poor performing and distressed firms separately.

Poor performing firms

Panel A of Table 6.1 shows the definition of restructuring strategies for the poorly performing sample. Operational restructuring covers cost rationalisation,

layoffs, closures and integration of production and other facilities. Asset restructuring includes both asset divestments and investments. Asset divestment comprises sell-off, management buy-out, spin-off, sale and leaseback, and other asset sales. Investment includes acquisitions and internal capital expenditures. Internal capital expenditure is measured by significant expenditure in plant and machinery, exceeding routine asset replacements. Since routine replacements, proxied by sample firms annual depreciation charge, averages 6.5%, internal capital expenditure is deemed to take place when such expenditure exceeds 10% of the pre-decline year total assets. Data on capital expenditure is based on company reports and accounts. For company reports and account-based values, values reported in accounting periods ending prior to 1st of May are deemed to relate to the previous year. Likewise, values reported in accounting periods ending on or after the 1st of May are deemed to relate to the current year. This classification is similar to that adopted by Syspas Limited.

Table 6.1: Definition of restructuring strategies
Panel A: Poor performing firms

Restructuring strategies selected by firms experiencing stock return performance decline are identified and defined. Information on strategies is from press releases to the London Stock Exchange which are documented by Extel Financial News Summary from 1987, with the exception of capital expenditure. Capital expenditure is defined as significant expenditure in excess of 10% of prior year asset value. The 10% limit is intended to capture expenditure significantly above routine asset replacement. Routine asset replacement, proxied by sample firms' depreciation charge, amounts to an average of 6.5% of prior year asset value. All strategies are dichotomous with the value 1 where adopted and value 0 where not adopted. Supplementary information is also collected from Hambro/Andersen Corporate Register and Company Guide, Datastream International, and Company Reports and Accounts. These alternative sources are also used for cross-checking information reported in the Extel Financial News Summary.

Strategy	Definition
<i>Operational restructuring</i>	
Operational restructuring	Cost rationalisation, layoffs, closures and integration of business units.
<i>Asset restructuring</i>	
Asset sales	Divestment of subsidiaries, management buy-outs, sale-and-leaseback, and other asset sales.
Acquisitions	Acquisitions leading to full or partial control of businesses.
Internal capital expenditure	Significant cash expended on fixed asset investments such as in plant and machinery, in excess of routine replacement of depreciated assets (at least 10% of pre-distress year total assets).
<i>Managerial restructuring</i>	
Managerial restructuring	Replacement of Chairman or Chief Executive Officer (includes Managing Director). Retirement under the age of 65 is treated as removal.
<i>Financial restructuring</i>	
Dividend cut or omission	Omission or reduction of dividends per share from pre-decline year level.
Equity issue	Significant cash raised from issue of new equity (excluding cash raised from routine exercising of share options and those with proceeds less than 1% of pre-decline year total assets and those where proceeds are applied specifically for financing acquisitions).
Debt restructuring	Debt refinancing involving extending maturity, converting (debt-equity swap) or forgiving of debt and interest.
<i>Combination strategies</i>	
Cash generative actions	Asset sales and/or cash equity issue.

Table 6.1: Definition of restructuring strategies (Contd.)**Panel B: Distressed firms**

All strategies are dichotomous with the value 1 where adopted and value 0 where not adopted. Source: Information on strategies from company's annual reports and accounts. Supplementary information also collected from Hambro/Andersen Corporate Register and Company Guide and Datastream International.

Strategy	Definition
<i>Operational restructuring</i>	
Operational restructuring	Expended cash on cost rationalisation, layoffs, closures and integration of business units.
<i>Asset restructuring</i>	
Asset sales	Significant cash raised from sale of fixed assets and subsidiaries (at least 5% of pre-distress year total assets).
Acquisitions	Significant cash expended on full and partial acquisitions of businesses (at least 5% of pre-distress year total assets).
Internal capital expenditure	Significant cash expended on fixed asset investments such as in plant and machinery, in excess of routine replacement of depreciated assets (at least 10% of pre-distress year total assets - see Panel A above).
<i>Managerial restructuring</i>	
Managerial restructuring	Removal of Chairman or Chief Executive Officer (includes Managing Director). Retirement under the age of 65 is treated as removal.
<i>Financial restructuring</i>	
Dividend cut/omission	Cut/omit dividend per share relative to pre-distress year level.
Equity issue	Significant cash raised from issue of new equity (excluding cash raised from routine exercising of share options and those with proceeds less than 1% of pre-distress year total assets and those where proceeds are applied specifically for financing acquisitions).
Debt restructuring	Debt refinancing involving extending maturity, converting (debt-equity swap) or forgiving of debt and interest.
<i>Combination strategies</i>	
Cash generative actions	Asset sales and/or equity issue.

Managerial restructuring covers replacement of Chairman or Chief Executive Officer (CEO). CEO covers the title Managing Director where the title CEO is not used. Retirement under the age of 65 is treated as removal as underperforming managers are sometimes forced to take early retirement (Warner, Watts and Wruck, 1988). Financial restructuring refers to both equity and debt-based strategies.

Equity issues and dividend cuts and omission are part of equity restructuring. Equity issues not made specifically for restructuring the firm's finances and alleviate financial distress eg. those for financing acquisitions, and routine exercising of share options and issues less than 1% of pre-decline year total assets are excluded. Dividend cut/omission refers to cut/omission in dividends per share relative to the pre-decline year. Debt restructuring includes debt refinancing and renegotiation of the terms of existing debt and debt for equity swaps. Cash generating strategies include asset sales and equity issues. Actions are identified from company announcements and news reports.

Distressed firms

Panel B of Table 6.1 shows the definition of restructuring strategies for the distressed sample. For distressed firms, we employ purely accounting report-based definition of restructuring actions, as opposed to news announcements used for poor stock performance firms, for two important reasons. First, the use of an accounting-based Z score computed from annual accounting reports necessitates

the classification of strategies over the same period. Though strategy announcement is swiftly reflected in stock returns it is not speedily reflected in Z scores. Put differently, there exists a serious mismatch between strategy announcements (which impact upon stock returns immediately) and actual financial movements reported in accounting periods (which impact upon the Z score). For example, if a divestment is announced in December 1993, its impact is reflected in stock returns in the same month. However, the actual financial impact of the divestment may be reported over many accounting periods. Significantly, since it is the actual accounting impact of a strategy and not its announcement that the Z score captures, the use of accounting-based proxies for turnaround strategies is imperative in this study. Secondly, of great interest is whether strategies extracted from accounting reports can predict changes in Z scores - scores based on composite accounting ratios. A model which predicts recovery in Z score from actions disclosed in accounting reports is therefore a potentially valuable complement to the Z score bankruptcy prediction model.

Operational restructuring covers the situation where cash is expended on costs rationalisation, layoffs, closures and integration of business units. Asset restructuring includes both asset divestment and new investment. Asset sales cover the situation where significant cash is generated from sale of fixed assets and subsidiaries/associates, in excess of 5% of pre-distress year total assets. The choice of 5% is arbitrary, but similar to that used by Ofek (1993) to define asset restructuring. The objective is to filter out insignificant routine managerial actions

which may be unconnected to performance decline. Investment covers the incidence of significant acquisitions (in excess of 5% of pre-distress year total assets) and significant internal capital expenditures (in excess of 10% of pre-distress year total assets).

As with the poor performing sample, managerial restructuring covers the replacement of Chairman or CEO. Again, the term CEO includes Managing Director where the title CEO is not used in a firm. Financial restructuring refers to both equity and debt-based strategies. Equity restructuring comprises equity issues and dividend cuts and omissions. Equity issues not made specifically for restructuring the firm's finances and alleviate financial distress eg. financing acquisitions, and routine exercising of share options and issues less than 1% of pre-decline year total assets are excluded. Dividend cut/omission refers to situations where there is a cut/omission in dividends per share relative to the pre-distress year level. Debt-based strategy refers to the incidence of debt restructuring. Debt restructuring covers situations from debt refinancing to renegotiation of the terms of existing debt and debt for equity swaps. Cash generating strategies refer to the adoption of either asset sales or equity issues or both strategies.

6.3.2 Testing for the impact of strategy and control variables on corporate recovery

As discussed in section 6.2.4, logit regression tests for the impact of

independent variables on recovery and non-recovery whilst OLS regression captures their impact on the extent of recovery.

Poor performing sample

In the logit regressions, the recovery or non-recovery to pre-decline stock returns ranking in the market i.e. 50th percentile or higher, in terms of two post-decline years' cumulative stock returns, is the dependent variable. As such, recovery is coded 1 and non-recovery is coded 0. The objective is to test the effectiveness of restructuring strategies over two post-decline years in effecting recovery.

In the OLS regression models, the two post-decline years' cumulative stock returns ranking in the market, is the dependent variable.

Distressed sample

In the logit regressions, the recovery or non-recovery to positive Z scores, two years post-decline, is the dependent variable. They are again coded 1 for recovery and 0 for non-recovery. Similar to the poor performance sample, the objective is to test the effectiveness of restructuring strategies over two post-distress years in effecting recovery³⁴.

In the OLS regressions, the change in Z score over two years post-decline from the pre-distress year is the dependent variable.

³⁴Z score is a measure of financial health and bankruptcy risk and not a returns measure. Therefore, the Z score at the end of the second year post-distress reflects the impact of restructuring strategies in the intervening two years post-distress. A return to positive score is indicative that the restructuring strategies have been effective.

6.4 Definitions of explanatory variables

6.4.1 Testing for the combined impact of agency and control variables on strategy choice

The main explanatory variables, agency monitoring variables representing different aspects of leverage, share ownership and board composition are summarised in Table 6.2. Leverage is the ratio of book value of total debt to book values of debt and equity³⁵. Leverage is further decomposed into three forms defined by ownership i.e. bank leverage, maturity i.e. short term leverage and security of debt i.e. unsecured leverage (all as a proportion of debt and equity). The leverage variables are not entirely mutually exclusive. For example, there may be an overlap between short term and bank leverage. This implies that when all the leverage variables are included in a regression, the empirical result has to be interpreted with caution.

Share ownership is proxied by directors' shareholding and block shareholding. Block shareholding is total of each individual holding of 5% or more (3% or more since 31st May 1990, see Companies Act 1989). Block shareholding is divided into shareholding by institutional (financial) and non-institutional holding. The latter is further split into associated and unassociated blocks. Associated blocks are held by families or trusts associated with the directors and company pension schemes.

³⁵The choice of book, rather than market, value of equity reflects the predominant use of the former measure in bank loan covenants (Lasfer et.al, 1996).

Table 6.2: Definition of agency monitoring and control variables

The table defines three groups of variables representing firms' agency monitoring mechanisms which are expected to influence the choice of restructuring strategies by poor performing firms. Debt structure is based on accounting information provided by Datastream International and Extel Company Research. Ownership and governance data are extracted from Hambro Corporate Register, Hambro Company Guide and Annual Reports and Accounts. Block shareholding is total of each individual holding of 5% or more (3% or more since 31st May 1990) as disclosed in the company annual reports. Internal causes of decline are per company press release and annual reports. GDP growth rates and Financial Times Actuaries (FTA) industry/sector returns are extracted from Datastream International.

Variable	Definition
<i>Debt structure</i>	
Leverage	Total book debt/(total book debt and equity).
Short term leverage	Short term debt/(total book debt and equity).
Bank leverage	Bank debt/(total book debt and equity).
Unsecured leverage	Unsecured debt/(total book debt and equity).
<i>Ownership structure</i>	
Managerial shareholding	Shareholding by members of the board of directors.
Affiliated block shareholding	Shareholding by family members or trusts of members of the board and company pension plans.
Institutional block shareholding	Shareholding by institutional investors.
Non-institutional unaffiliated block shareholding	Shareholding by non-institutional blockholders unaffiliated to management.
<i>Governance structure</i>	
CEO-duality	Combined role of Chairman and Chief Executive Officer (Chairman cum CEO)
Non-executive Chairperson	Chairperson in non-executive capacity.
Outside directors	Non-executive directors as a percentage of total number of directors.

Table 6.2: Definition of agency monitoring and control variables (Contd.)

<i>Control variables</i>	
Severity of decline	Stock returns ranking (or Z score) in the year of decline
Internal causes of decline	Reported internal causes such as project failures, bad acquisitions or poor financial control.
Economic condition	GDP growth rate in the year of restructuring.
Industry condition	FTA industry average log return (Z score of median firm in distressed firm's industry sector) in the year of restructuring.
Size	Log of market value of equity (log of total assets) in the pre-decline year.

Board composition is proxied by three variables: proportion of outside or non-executive directors on the board, whether the board is chaired by a non-executive director, and CEO cum Chairman (CEO duality) where the two posts are held by the same person.

As discussed in Section 4.4, the empirical literature suggests that turnaround strategy choices are also dictated by non-agency monitoring factors. These additional variables - severity of decline, economic and industry downturn, and firm-specific cause of decline - are included in our regressions as contextual control variables. As the definitions for control variables may differ between the poor performing and distressed samples, due to difference in choice of performance measure, the definition for the latter group is included in parentheses, where such difference arises.

Severity of decline is measured by the stock returns rankings (Z score) in the year of decline. The lower the firm's stock returns ranking (Z score) the more

severe would the performance decline be. Firm-specific causes of decline are identified from company press release and directors' comments in annual reports and accounts. Economic condition is measured by the GDP growth rate whilst industry condition is represented by the firm's Financial Times-Actuaries [FTA] industry log return (Z score of median firm in the distressed firm's industry sector). Size of the firm is proxied by log of market value of equity (total assets) in the pre-decline year. Internal cause of decline, CEO duality and non-executive Chairmen are each represented by a dummy variable (1 where it exists and 0 if otherwise).

6.4.2 Testing for the impact of intensity of strategy and control variables on corporate recovery

The main explanatory variables are the intensity of restructuring strategies firms adopt to turnaround their performance. Intensity of restructuring is measured using accounting and cash flow data relative to their pre-decline deflator or value³⁶ and is summarised in Table 6.3.

³⁶The choice of pre-decline values is based on the need to avoid contamination by severity of decline. For example, severe decline firms by construct will have a more severe drop in assets. Thus, a \$10 million asset sales by similar-sized firms in the pre-decline period, may be artificially more intensive for the severe decline firms than for the less severe decline firms. If measured relative to post-decline value of such firms.

Table 6.3: Definition of intensity of restructuring strategies

Sources: Extel Financial News Summary, Company Reports and Accounts and Datastream International.

Strategy	Definition
<i>Operational restructuring</i> Operational restructuring	Costs of rationalisation, layoffs, closures and integration of business units/pre-decline year total assets.
<i>Asset restructuring</i> Asset sales	Value of divestment of subsidiaries and other asset sales/pre-decline year total assets.
Acquisitions	Costs of full and partial acquisitions of businesses/pre-decline year total assets.
Internal capital expenditure	Capital expenditure on fixed assets such as plant and machinery/pre-decline year total assets.
<i>Managerial restructuring</i> Managerial restructuring	Number of changes in executive and non-executive directors/pre-decline year total number of directors.
<i>Financial restructuring</i> Dividend cut or omission	Percentage change in dividend per share from pre-decline year's (omission is equal to -100%).
Equity issue	Cash raised from equity issue/pre-decline year total assets.

Operational restructuring is measured by the ratio of cost of restructuring as reported in the company accounts to pre-decline year total assets. Where information is available, only costs related to operational restructuring such as redundancy, closures, integration and operating asset writeoffs ie. stocks and debtors, are included. Care is taken to exclude any items unrelated to operations

such as provisions for loss on sale of assets or businesses. Asset reduction, acquisition and capital expenditure are measured by the cash flows expended deflated by pre-decline year total assets.

Management changes are represented by the number of changes in executive and non-executive directors as a proportion of pre-decline year total number of directors. We take the opinion that board turnover provides a richer measure of the intensity of management changes than merely changes in Chairman and CEO. However, due to the lack of detailed news on changes in directors other than the Chairman and CEO prior to 1987 (first year such information is published by Extel), we are not able to compute intensity of management changes for the distressed sample.

Dividend change is the percentage change in current year dividends from the pre-decline year's. Equity issue is measured by cash raised by equity issue as a proportion of pre-decline year total assets. Debt restructuring e.g. forgiving of debt and interests, is difficult to measure, and is therefore included only as a dummy variable ie. 1 if the strategy is adopted and 0 if otherwise. The above intensity definitions are summarised in Table 6.3. As discussed in Section 5.4, the literature also suggests that turnaround strategy effectiveness is also conditional upon other control factors. These additional variables i.e. severity of decline, economic and industry downturn, and firm-specific cause of decline, are included as control variables (see Table 6.2 for their definition).

6.5 Data

6.5.1 Poor performing firms sampling

Determinants of corporate restructuring strategies

As stated earlier in Section 6.2.1, sample firms are those which experience a sharp decline in their relative stock return performance. On a ranking of log annual stock returns (capital gains and dividends) of all London Stock Exchange listed firms, firms which fall into the bottom 20% in a year (decline year) after having been in the top 50% in the previous two years (base years) are sampled. This sampling criterion is called the 50:50:20 rule. The sample covers the period 1985-93, with 1985-91 as the base years and 1987-1993 as the decline years. The reason for 1987 as the first decline year is that the main source for restructuring news i.e. Extel Financial News Summary, was first published in 1987.

Datastream International is the data source for annual stock returns. An initial sample of 415 declining firms satisfying our 50:50:20 rule is assembled from a total of 3706 firms covered by Datastream over the period 1985-1993³⁷. Sampling excludes tightly regulated financials and utilities, and firms with a market capitalisation of less than £10m. Small firms are excluded for want of sufficient data on their restructuring.

Data on the sample firms' restructuring activities and on the explanatory variables are collected from Datastream International, company annual reports and

³⁷High variance in returns does not appear to cause the performance decline in our sample firms. Indeed, the sample betas are not unusual (mean and median values are both less than 1) and unlikely to cause the stock returns decline.

Extel Annual News Summaries. Such data are not available for all companies defined as poor performing. The final sample consists of 297 poor performing firms.

Effectiveness of corporate restructuring strategies

Turnaround is defined, in this research, as recovery to pre-decline performance over two years post-decline. As 1994 is the last year of publication of Extel Annual Financial News Summary, firms experiencing a performance decline in 1993 are excluded. The reduced sample, before allowing for takeovers and failures, for the purpose of examining effectiveness of strategies, consists of 229 poor performing firms.

6.5.2 Distressed firms sampling

Determinants of corporate restructuring strategies

As stated earlier in Section 6.2.1, sample firms are those which experience a sharp decline to a negative Z score after having had a positive Z score for at least two consecutive years. This sampling criterion is called the ++- (plus, plus, minus) rule. The sample covers the period 1983-93, with 1983-91 as the base years and 1985-1993 as the distress years. Z scores are provided by Syspas Limited³⁸. Due to the choice of accounting report-based strategy definition for the distressed sample (see section 6.3.1), the sample period is not limited to the publication of Extel's Annual Financial News Summary which commences in 1987. Further,

³⁸Sypas is an acronym for System Performance Analysis Services.

using a longer sampling period allows the sampling of distressed firms under a wide range of economic conditions.

An initial sample of 245 distressed firms satisfying our +-+ rule is assembled from a total of 976 FT-All Share firms listed on the London Stock Exchange in the period 1983-1993. The restriction to FT-All Share firms is due to the fact that, at the time of the study, a complete database of Z scores dating back to 1983 was only available for FT-All Share firms. Sampling excludes tightly regulated financials and utilities, and firms with a market capitalisation of less than £10m. Small firms are excluded for want of sufficient information on their restructuring.

Due to the different sampling periods and definitions of performance decline, the poor performing and distressed samples are expected to have few overlap in memberships. One is not necessarily a subset of the other.

Data on the sample firms' restructuring activities and on the explanatory variables are collected from Datastream International, company annual reports and Extel Annual News Summaries. Such data were not available for all distressed companies. The final sample consists of 201 distressed firms.

Effectiveness of corporate restructuring strategies

Again, turnaround is defined, in this research, as recovery to pre-distress performance over two years post-distress. Due to incomplete post-distress accounting data, firms experiencing a financial distress in 1993 are excluded. The

reduced sample, for the purpose of examining effectiveness of strategies, consists of 166 distressed firms with a minimum of two years post-distress restructuring data.

6.6 Sample characteristics

6.6.1 Poor performing firms

Table 6.4 provides the descriptive statistics for the sample of poor performance firms. From Panel A, the mean (median) annual returns for the sample in the base and distress years are: 42% (36%) (base year -2), 33% (28%) (base year -1) and -51% (-38%) (decline year). The returns to the Financial Times All Share (FTA) Index in the same years are: 16%, 15% and 16% respectively.

The sample firms clearly outperform the market in the base years (except for returns in the year 1989)³⁹ and underperform it in the decline year. Moreover, the decline in performance for the sample is also very steep. This pattern of steep decline is repeated for each of the sample decline years 1987 to 1993. The sample median returns in the base years range from -6% in 1990 (decline year 1991), a recession period, to 53% in 1986 (decline year 1988). In the decline years the median return ranges from -12% in 1993 to -112% in 1990.

³⁹It should be borne in mind that although the Financial Times All-Share Index covers around 800 firms, it is not a full market index. In addition, it is a value weighted index whilst our average returns are equally weighted. Hence, it is not surprising that, occasionally, a firm ranked among the top 50% in stock returns term, underperform the Financial Times All-Share Index.

Table 6.4: Descriptive statistics of sample firms' financial performance:

Poor performance sample

Panel A shows the sample firms' stock returns in the two years prior to and including the year of decline. Return on the Financial Times All Share Index (FT-All), a value-weighted index based on around 800 firms covering in excess of 90% of stock market capitalisation on the London Stock Exchange, is provided for comparison. All returns are log returns (capital gains and dividends). Panel B shows changes in accounting based performance in the year of decline. PBIT = profit before interest and tax. Earnings per share (EPS) = profit after tax, minority interests and preference dividends but before extraordinary items / the average number of shares in issue in the year. Return on equity = profit attributable to shareholders / share capital and reserves less intangibles. Return on assets = profit before interest and tax / total assets less current liabilities. PBITD = profit before interest and tax plus depreciation (proxy for cash flows). Total debt is the total of all interest-bearing debt i.e. short, long and subordinated debt. Capital employed is the sum of book debt plus book equity. Beta is based on figures computed by the Risk Measurement Service of the London Business School, at the beginning of the year prior to decline. Size is market capitalisation at the beginning of the year of decline. In Panel B the mean and median are tested using the t-test and the non-parametric Mann-Whitney Wilcoxon test. *** indicates significance at 1%. Sources: Datastream International, Extel Financial, and London Business School.

Panel A: Annual stock returns (%) in the year of, one and two years prior to, decline

	Returns in decline		Returns in decline		Returns in decline		
	year-2		year-1		year		
	No.	Mean	Med.	Mean	Med.	Mean	Med.
Total sample	297	42.2	35.56	32.63	28.07	-51.12	-37.87
FT-All Share		16.15		14.59		16.29	
Decline year, 1987	41	40.3	33.65	50.2	41.2	-30.1	-23.97
FT-All Share		18.3		24.3		7.7	
Decline year, 1988	55	61.1	52.85	49.2	40.49	-39.7	-33.41
FT-All Share		24.3		7.7		11	
Decline year, 1989	54	44.1	39.46	28.7	23.61	-50.2	-41.72
FT-All Share		7.7		11		30.8	
Decline year 1990	32	38.4	35.14	32.7	25.98	-131	-112.31
FT-All Share		11		30.8		-10.3	
Decline year, 1991	28	23.9	20.58	-7	-6.19	-59.2	-54.03
FT-All Share		30.8		-10.3		18.9	
Decline year, 1992	19	1.6	2.79	36	24.88	-95.7	-80.53
FT-All Share		-10.3		18.9		18.7	
Decline year, 1993	68	47.2	40.51	27.1	23.06	-20.4	-11.58
FT-All Share		18.9		18.7		25.1	

Table 6.4: Descriptive statistics of sample firms' financial performance:

Poor performance sample (Contd.)					
Panel B: Changes in profitability and cash flows in the year of decline from					
the base years					
	Average of two	Decline			
	pre- decline years	year			
	Mean (%)	Mean (%)	t stat.	z stat.	
PBIT/Sales	10.72	7.05	4.23***	9.30***	
Earnings per share growth	29.15	-26.93	18.88***	13.15***	
Return on equity	19.12	13.87	5.06***	7.04***	
Return on asset	22.65	15.3	8.26***	9.02***	
PBITD/Capital employed	30.1	23.69	6.94***	7.27***	
PBITD/Total Debt	140.45	53.82	13.50***	11.36***	
	Min	Max	Stdev	Mean	Median
Risk (beta)	0.05	1.49	0.21	0.95	0.96
Size (£M)	10			344.2	54.8

Panel B of Table 6.4 gives the performance statistics based on accounting variables. Both profitability and cash flows deteriorate significantly in the decline year from the average of the two base years. The fall in mean values for the profitability measures - operating margin, earnings per share, return on equity and return on assets - ranges from 28% (return on equity) to 192% (earnings per share growth), all significant at 1%. Fall in mean values of operating cash flows - profit before interest, tax and depreciation (PBITD) deflated by capital employed and total debts - are 21% and 62% respectively, both significant at 1%.

The accounting-based performance measures thus reflect the stock return

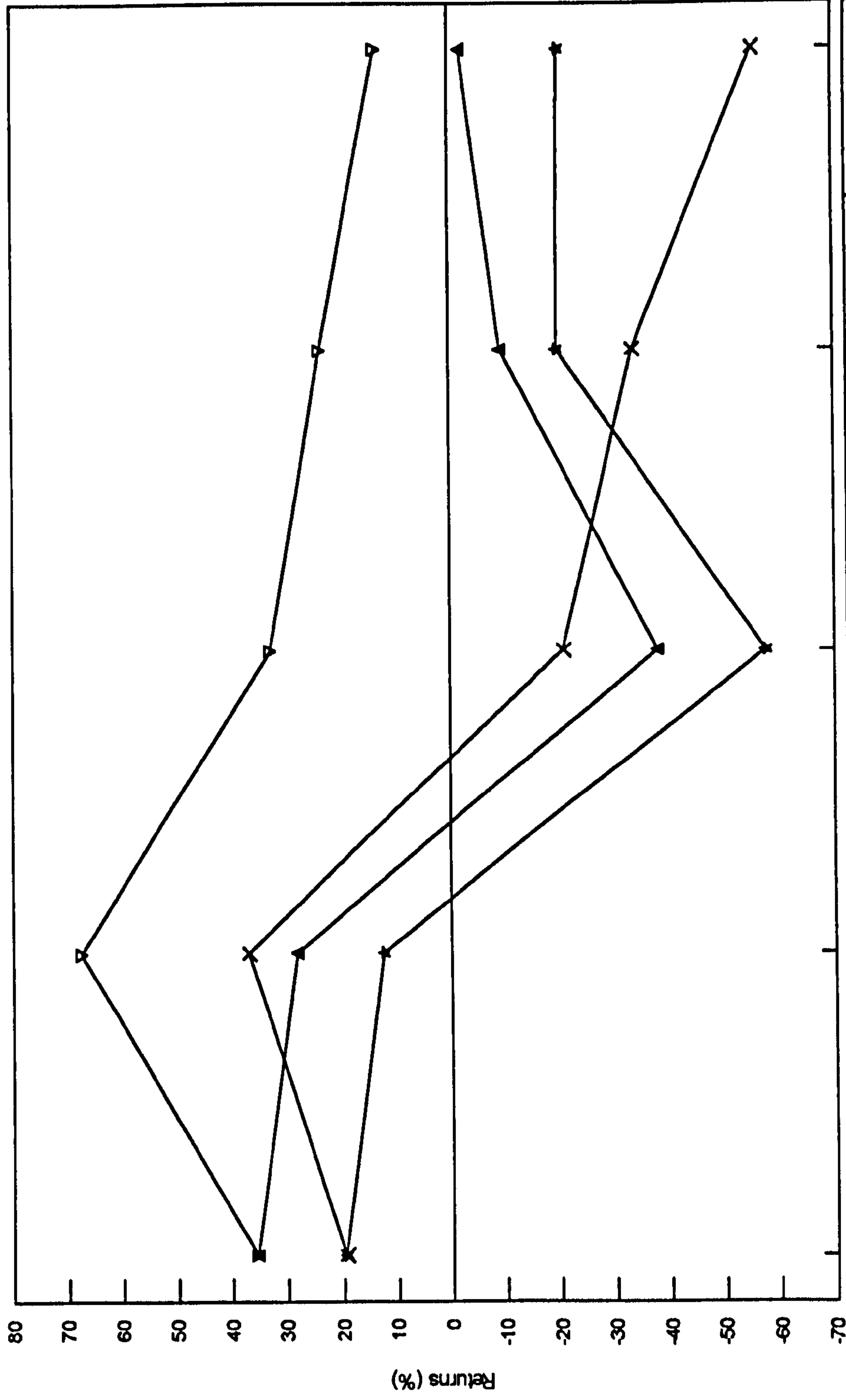
decline. Our sample thus captures both operating performance and stock return performance decline. The similarity of performance decline in both stock return and accounting terms suggests that the stock return decline is not freak caused by correction of stock market overreaction in the base years unrelated to underlying operating performance (see Section 2.5). Excess volatility due to high beta stocks in the sample does not appear to cause the performance decline in our sample firms. Indeed, the sample betas are not unusual (mean and median values are both less than 1) and unlikely to cause the stock returns decline.

Figure 6.1 provides a graphical presentation of sample firms pre- and post-decline median annual and cumulative stock returns. Focusing on the cumulative market-adjusted returns (MAR), sample firms enjoyed returns 37% in excess of the market two years prior to decline. However, the decline is significantly steep bringing the three-year cumulative MAR returns to -21% in the decline year.

The decline is clearly not a short term market anomaly as the median firm continues to slide in performance for two years resulting in five years cumulative market-adjusted losses of 56% two years post decline. Therefore, the 50:50:20 sampling criterion is robust.

Figure 6.1. Sample firms' pre- and post-decline median annual and cumulative returns: Poor performance sample
Raw returns are natural log returns. MAR denotes market adjusted log returns. Source: Datastream International and Financial

Times Extel



Year relative to decline	-2	-1	0	1	2
▲ Raw	35.56	28.07	-37.87	-9.46	-2.12
★ MAR	19.44	12.17	-57.69	-19.8	-19.94
▽ Cum raw	35.56	67.66	32.94	23.75	13.44
X Cum MAR	19.44	37.01	-20.64	-33.56	-55.63

Agency monitoring mechanisms and restructuring strategies

Panel A of Table 6.5 provides descriptive statistics on the leverage, share ownership and governance structure in base year -1. The median leverage, total book debt to book debt and equity, is 27% and median short term debt, bank debt and unsecured debt as proportions of book debt and equity are in the range 12% to 16%.

Median directors' shareholding is 9.5% and associated block holding is negligible. Institutional ownership amounts to a median value of 6.9%. Non-institutional but unassociated block holding has a median of 0% (but a mean of 7%).

Comparison with the only other study by Ofek (1993) that examines the determinants of restructuring strategy choice during performance decline reveals interesting differences in agency mechanism between US and UK firms. Ofek reports median leverage, managerial shareholding and outside (non-managerial) shareholding of 31%, 22% and 6% respectively. This compares with our sample's 27%, 9.5% and 6.9% (to maintain clarity of table 6.5, outside shareholding, per Ofek's definition, is not shown in the table).

As regards board composition, in 44% of sample firms one person plays the dual roles of Chairman and CEO. Non-executive Chairmen preside over the board in 25% of the companies. The median proportion of outside directors in the sample boards is 22%.

Table 6.5: Descriptive statistics for independent variables: Poor performance sample

Panel A shows the descriptive statistics for the explanatory variables in the pre-decline year. For definitions of the variables see Table 6.2. Panel B shows the distribution of corporate restructuring actions in the year of decline and first and second years post-decline. In Panel A Chairman cum CEO, and Non-executive Chairmen are dummy variables coded as 1 when either is the case and 0 if otherwise. For these two variables mean is the sample proportion of firms with code value 1. In Panel B, internal cause of decline is a dummy variable coded as 1 when there is an internal cause of decline and 0 if otherwise. For definitions of the variables see Table 6.2. Sample size declines in Panel B due to failure of firm, takeover or where no data are available i.e. firms declining in 1993 (68 firms) are excluded from decline year+2 analysis.

Panel A: Descriptive statistics for agency variables

Agency variables	Mean	Med.
<i>Capital structure</i>		
Leverage	0.29	0.27
Short term leverage	0.13	0.12
Bank leverage	0.18	0.16
Unsecured leverage	0.16	0.12
<i>Ownership structure (%)</i>		
Managerial shareholding	19.90	9.5
Associated block shareholding	0.71	0.0
Institutional block shareholding	12.2	6.9
Non-institutional unassociated block shareholding	7.1	0.0
<i>Governance structure</i>		
Chairman cum CEO	0.44	-
Non-executive Chairman	0.25	-
Proportion of outside directors (%)	20.0	22.0

Table 6.5: Descriptive statistics for independent variables: Poor performance sample (Contd.)

Panel B: Descriptive statistics for control variables

	Mean		Median			
<i>Control variables</i>						
Internal cause of decline	0.30		-			
Severity of decline	10.8		10.9			
Size (£M)	344.2		54.8			
	Decline year		Decline year+1		Decline year+2	
	Mean	Med.	Mean	Med.	Mean	Med.
Economic condition	2.27	2.34	2.08	2.34	0.68	0.70
Industry condition	7.80	11.29	3.60	7.80	-32.75	-16.88

According to Chairmen and directors' report, one in three cases of poor performance is caused by an internal firm-specific problem. Admittedly, this figure can be higher as some managers may be reluctant to admit that there is an internal cause of decline, perhaps to avoid blame for the decline. Sample firms' severity of decline proxied by stock returns ranking in the market in the year of decline unsurprisingly averages 10%. The average size of sample firms is \$344m but the median size is only \$55m. Sample firms appear to enjoy good economic and industry condition until two years after decline. Hence, adverse industry and economic conditions do not appear to be a cause of decline. However, it highlights the importance of controlling for external environment during the post-decline restructuring period.

Frequency of turnaround strategies

Panel A of Table 6.6 reports the frequencies of sample firms undertaking different turnaround strategies in the decline year and in the two post-decline years. We find that the most frequent form of restructuring is operational with 59% of the sample firms undertaking it in the decline year and 47% and 52% of the firms in the two following years. This is comparable to Ofek's 53% for the decline year.

Asset sales are carried out by between 27% and 38% of the firms in those years. This is much higher than the 15% rate reported by Ofek (1993) for the decline year. Surprisingly, acquisitions do not cease when firms hit trouble and they are carried out by nearly 50% of the sample firms in the decline year and by 36% and 27% of the firms in the post-decline years. Internal capital expenditure, again surprisingly, does not cease but is incurred by 62% of firms in the decline year and by 50% and 48% in the following years.

Removal of top management is observed in 20% (in the decline year) to 26% (in decline year+1) of the sample firms. Again, Ofek (1993) reports a similar 21% of top management replacement in the year of decline.

Table 6.6: Descriptive statistics for dependent variables: Poor performance sample

This table shows the distribution of corporate restructuring actions in the year of decline, one year, and two years post-decline. Frequency is the proportion of sample firm adopting the strategy. For definition of variables see Table 6.1. Sample size declines in post-decline years due to failure of firm, takeover or where no data is available i.e. firms declining in 1993 (68 firms) are excluded from decline year+2 analysis. Source: Company press releases and Company Reports and Accounts.

Panel A: Descriptive statistics for restructuring strategies in the year of, first year after, and second year after decline

	Decline year	Decline year+1	Decline year+2	Any of the three years
Sample size	297	270	188	188
Restructuring strategy	Frequency (%)	Frequency (%)	Frequency (%)	Frequency (%)
<i>Operational restructuring</i>				
Cost rationalisation, layoffs, closures and integration of business units	58.6	46.7	51.6	83.5
<i>Asset restructuring</i>				
Asset sales	26.6	37.8	35.6	61.2
Acquisitions	50.2	35.9	27.1	70.7
Internal capital expenditure	61.6	50.4	47.9	74.5
<i>Managerial restructuring</i>				
Replace top management	19.5	25.9	21.8	49.5
<i>Financial restructuring</i>				
Dividend cut or omission	23.6	27.0	34.0	54.3
Equity issue	20.2	10.4	13.3	39.9
Debt restructuring	2.4	3.3	7.4	11.7
<i>Cash generative actions</i>	40.1	44.1	43.6	71.3

**Panel B: Frequency of restructuring strategies pursued by UK listed firms
during the period 1989-1994.**

Frequency is the annual average of strategies taken. Asset sales cover divestments, management buy-outs and other asset sales. Acquisitions represent full and partial acquisitions. Dividend cut/omission refers to cut/omission in dividends per share over the previous year. Rights issue encompasses rights issue, rights offer, offer for sale, open offer and placing of firm shares with institutions and financial intermediaries. Source: FT Extel Company Research.

Average no. of firms	Asset sales %	Acquisitions %	Dividend cut/omission %	Rights issue %	Cash generative actions %
1521	19.6	34.5	20.8	15.2	31.6%

Debt restructuring is quite infrequent with only 2% of sample firms in the decline year and 3% and 7% in the following years respectively taking recourse to it. In contrast, Ofek (1993) finds 11% of his sample firms restructure their debt in the year of decline. Debt restructuring appears to be more common among US than UK firms (only 4% of firms declining to the bottom 10% i.e. 50:50:10 firms, adopt it in the decline year). Equity issues are made by 20% of sample firms in the decline year but by only about 10% in the following years. The most frequently employed financial restructuring device is dividend cut or omission. The proportions of firms adopting this strategy in the three years are: 24%, 27% and 34%.

Over the three-year period, from decline to two post-decline years, in excess of 80% of sample firms restructure their operations. About 70% of firms adopt cash generative actions - 61% sell assets and 40% make equity issues. Similar proportions (70% and 74%) make acquisitions and internal capital expenditure. Nearly half of sample firms replace their Chairman or CEO in the three year period. About 54% of firms resort to dividend cut/omission to stave off financial crisis. However, only 12% need to, or succeed in, restructuring their debts.

An interesting question to ask is how does the frequency of strategies followed by performance decline firms compare with that in the population of firms listed in the UK. Do these frequencies differ from the population benchmarks and why?. Panel B of Table 6.6 provides answers to these questions where population data are available. From an extensive search of financial news reported by firms and reported by Extel in their Company Research CD-ROM, we manage to compile the average number of firms in the population adopting asset sales, acquisition, dividend cut/omission, rights issue and cash generative actions, during the period 1989-1994. The period coincides mostly with the period under study, and the year 1989 is the first year covered by the Company Research CD-ROM.

Unsurprisingly, higher proportion of our sample firms (33% - average of three years) sell their assets than the average firm in the population (20%)⁴⁰, from

⁴⁰The population figure is the average of the population for the period 1989-1994. The same benchmark population is used in the rest of this section. It should be noted that the

the year of decline to two years thereafter. In the case of acquisitions, sample firms clearly overtake the population with 50% versus 35% of firms in the population making acquisitions in the year of decline. However, with the onset of decline, sample firms reduce their rate of acquisitions to the population rate one year after decline. Two years post-decline, far fewer sample firms seek acquisitions compared to the population. A similar pattern is observed with regard to equity rights issue. More sample firms tap the market than the population at large, 20% in the decline year, versus 15% in the population. However, sample firms are likely to be less successful in raising finance from equity investors subsequent to performance decline, than the average firm in the population. Finally, more sample firms resort to cash generative actions than the population with an annual average of 41% of sample firms taking it compared to only 32% of firms in the population. Overall, our sample of declining firms carries out various restructuring activities more intensively than the population at large.

Correlations among explanatory and control variables

Table 6.7 reports the correlation matrix among the explanatory and control variables. Out of a total 105 pairwise correlations among 15 variables, only 8 exceed 0.30 and only 4 equals or exceed 0.20. The two largest correlations are between bank leverage and short term leverage (0.36), non-executive Chairman and Chairman cum CEO (-0.51).

population includes the sample firm. Hence, comparison is not between two independent groups.

Table 6.7 Pearson correlation coefficients among the explanatory and control variables: Poor performance sample

The variables are defined in Table 6.3. Only values of 0.2 or greater are highlighted in bold.

Variable	1	2	3	4	5	6	7	8	9	10	11	12	13	14
1 Short term leverage														
2 Bank leverage	0.53													
3 Unsecured leverage	0.35	0.33												
4 Managerial shareholding	-0.01	-0.01	-0.18											
5 Institutional shareholding	-0.03	-0.05	0.03	-0.32										
6 Non-institutional unassociated block shareholding	0.01	0.02	-0.01	-0.19	-0.21									
7 Manager-associated shareholding	0.08	0.06	-0.06	-0.02	-0.05	-0.02								
8 Chairman cum CEO	0.05	-0.06	-0.05	0.17	-0.05	-0.16	0.03							
9 Non-executive Chairman	-0.11	-0.06	-0.05	-0.18	0.13	0.17	-0.09	-0.51						
10 Proportion of outside directors	-0.02	-0.01	0.12	-0.26	0.14	0.16	-0.04	-0.25	0.33					
11 Economic condition	-0.07	-0.14	-0.07	0.00	-0.14	-0.14	0.04	0.06	-0.05	-0.11				
12 Industry condition	0.01	-0.03	-0.10	0.01	0.12	0.03	-0.02	0.05	0.01	-0.04	0.15			
13 Internal problem	0.13	0.00	0.06	-0.02	-0.02	0.01	-0.08	0.01	0.08	-0.02	0.19	0.00		
14 Severity of decline	-0.06	-0.02	-0.03	-0.07	0.10	-0.03	-0.01	-0.07	0.11	0.03	-0.09	0.03	-0.14	
15 Size	-0.05	-0.03	0.37	-0.36	-0.12	-0.04	-0.09	-0.08	0.05	0.24	-0.04	-0.10	-0.06	0.10

The high positive relation between bank leverage and short term leverage is typical of UK firms as they tend to have significant amounts of short term bank borrowings in the form of bank overdrafts and short term loans. The negative correlation between non-executive Chairman and Chairman cum CEO is less than 1.00 as executive Chairmanship may be jointly held by CEO or independently held by a separate person.

Interestingly, managerial shareholding is negatively related to size (-0.36), institutional shareholding (-0.32) and proportion of outside directors (-0.26). The inverse relationship between managerial shareholding and firm size may lie in the declining ability of managers to subscribe to large equity stakes as firms get larger. Also, large firms are traded and followed more frequently by analysts, hence the larger presence of institutions. An alternative explanation, consistent with the agency model, is that where managers' shareholding is low, and managers' incentives are potentially weakly aligned to those of shareholders, managers are kept on their toes by greater monitoring by institutional shareholders and outside directors (Bathala, Moon and Rao, 1994).

Taking the agency view again, where the Chairman is in a non-executive capacity, governance is enhanced by a higher proportion of outside directors. However, where the Chairman is also the CEO, board monitoring is further weakened by the tendency to have a lower proportion of outside directors in the board. This highlights the potential detrimental effects of an entrenched Chairman cum CEO. The power of the Chairman cum CEO appears to be premised on or reinforced by high managerial shareholding.

Finally, larger firms appear to have a higher proportion of outside directors than smaller firms. This may reflect the substitution of outside director monitoring for managerial-incentive alignment, due to managers' small shareholding, in large firms. Alternatively, large firms' attraction of institutional shareholders and in turn institutional shareholders' preference for outside director monitoring may give rise to higher proportion of outside directors in big than in small firms.

Given the above weak correlations, collinearity may not be a problem in the regression models discussed earlier. However, we shall run regressions based on simplified explanatory variables such as one leverage variables i.e. total leverage, and two equity shareholding i.e. inside and outside shareholding, instead of four, to ensure robustness of results and mitigate the impact of multi-collinearity. Inside shareholding comprises managerial and manager-associated shareholding. Outside shareholding is made up of institutional and non-institutional unassociated shareholding. To test for the impact of lender and ownership types on restructuring strategy choice, we shall rerun all the regressions with the three lender types and four shareholder types described in Section 4.2.

Poor performing firms' financial status two years post-decline

Table 6.8 shows the financial status of sample firms two years after decline. Over that period, more than a third recover whilst nearly half of sample firms do not recover to their pre-decline performance. The remainder of sample firms is either taken over (12.2%) or become insolvent (5.7%). A firm is declared insolvent when an administrator or receiver is appointed to the firm. The rate of recovery fluctuates between a low of 22% to a high of 49%.

Table 6.8: Financial status two years post-decline: Poor performance

sample

This table shows the financial status of sample firms two year's post-decline. Over that period, firms may be taken over, become insolvent, recover, deteriorate into severe decline or merely survive. Recovery is defined as the return to top 50% rank in two years' cumulative stock returns on the market whilst severe decline is defined as remaining in the bottom 20% rank in the market two years post-decline. Mere survivors are firms which recover in their returns to above the 20% rank threshold but have yet reached their pre-decline performance i.e. top 50% rank. Firms in severe decline or merely surviving are collectively termed non-recovery firms.

Decline Year	Taken over		Insolvent		Recovery		Non recovery leading to				Total	
	No.	%	No.	%	No.	%	Severe decline		Mere survival		No.	%
87	7	17.1	-	-	20	48.8	7	17.1	7	17.1	41	17.9
88	7	12.7	1	1.8	12	21.8	14	25.5	21	38.2	55	24
89	7	13.0	5	9.3	17	31.5	12	22.2	13	24.1	54	23.6
90	4	12.5	5	15.6	9	28.1	11	34.4	3	9.4	32	14
91	3	10.7	1	3.6	11	39.3	4	14.3	9	32.1	28	12.2
92	-	-	1	5.3	8	42.1	6	31.6	4	21.1	19	8.3
Total	28	12.2	13	5.7	77	33.6	54	23.6	57	24.9	229	100

It is clear that firms that decline prior to or during an economic downturn (distress years 1988-1990) have a much tougher turnaround job i.e. smaller chance of recovery, than do firms that decline in other economic conditions. The final sample of recovery and non-recovery firms, excluding those taken over or becoming insolvent, comprises 188 firms, with a minimum of two years post-decline restructuring data.

Figure 6.2 shows sample firms' pre- and post-decline annual and cumulative market-adjusted log returns respectively. Returns are median returns in the sample groups. Both groups out perform the market in the two years preceding decline, and underperform the market in the decline year. Non-recovery firms, however, continue to underperform the market by a wide margin whilst recovery firms surge ahead of the market consistently in the two-year post-decline. In terms of five year cumulative returns, recovery and non-recovery firms underperform the market by 16% and 106% respectively.

A similar pattern is observed in operating performance two years' post-decline, as shown in Table 6.9. Recovery firms record marked improvements in operating performance, based on two year average post-decline performance compared to the decline year. All six performance indicators register improvements, although only four are statistically significant based on either the t statistic or non-parametric Mann-Whitney Wilcoxon tests or both. They are earnings per share growth, return on equity, return on assets and debt cover i.e. operating cash flow to total debt.

Figure 6.2: Recovery and non-recovery firms median annual and cumulative market-adjusted log returns from two years pre-decline to two years post-decline: Poor performance sample

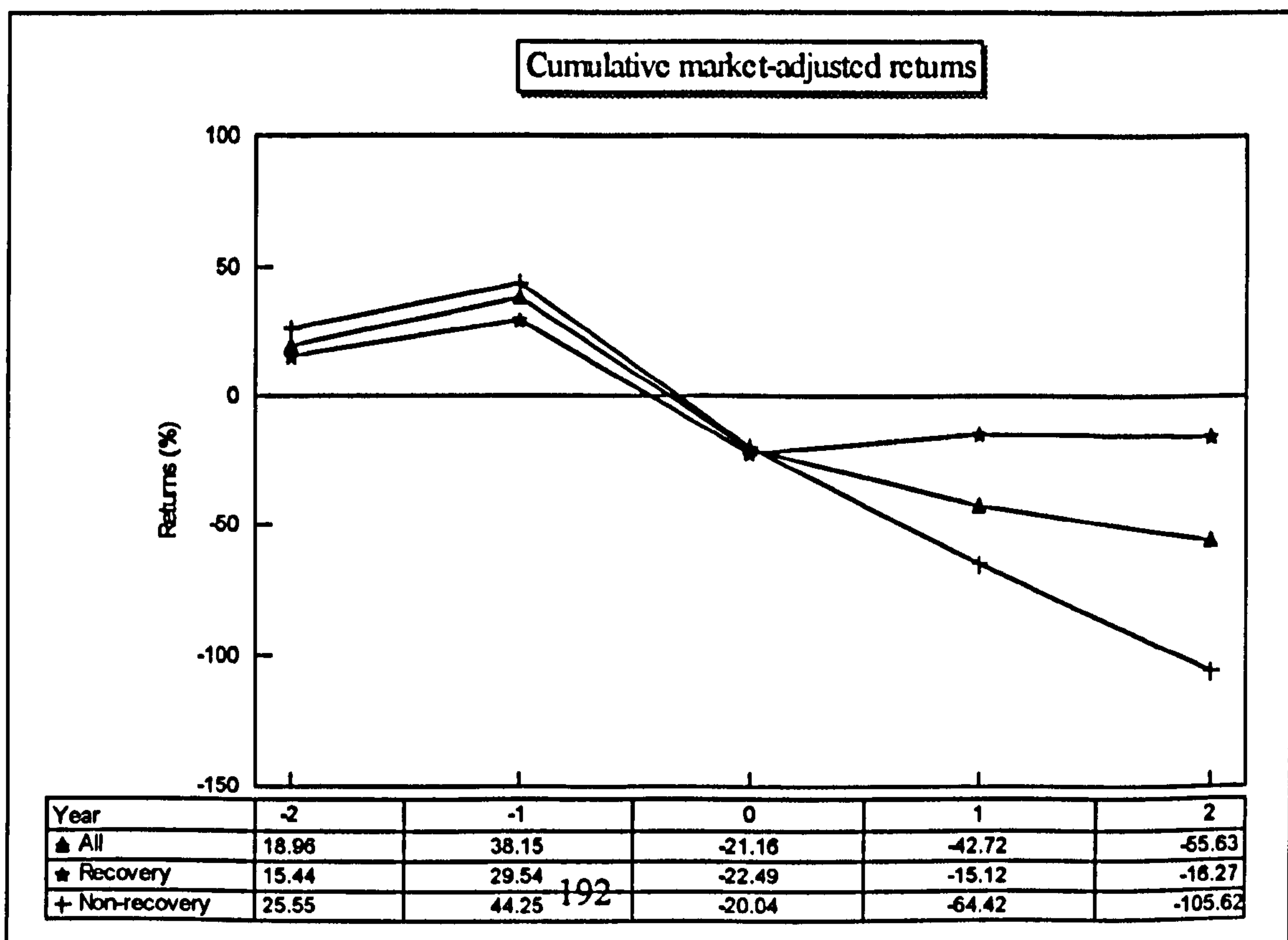
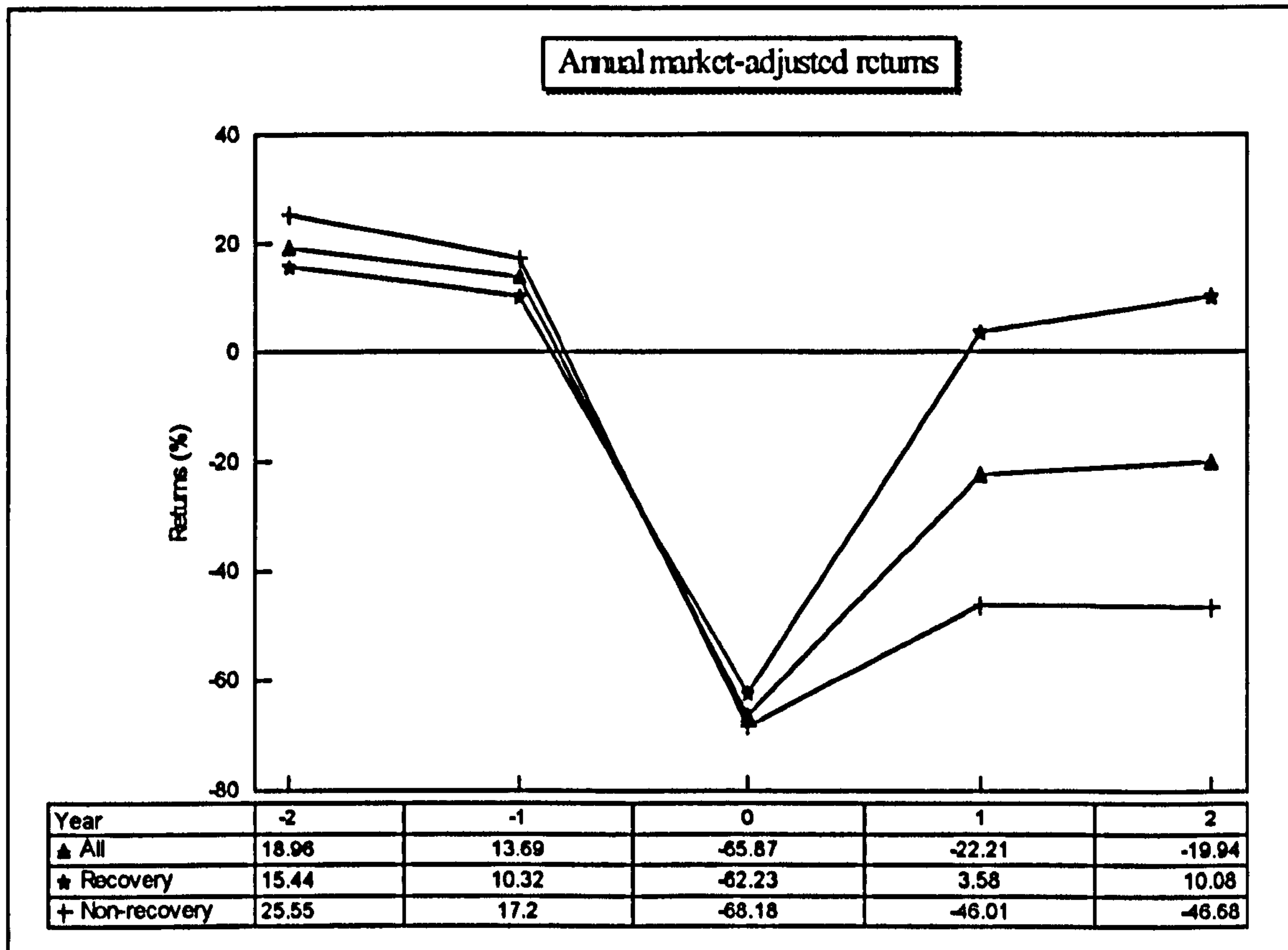


Table 6.9: Descriptive statistics of sample firms' post-decline financial performance: Poor performance sample

Changes in profitability and cash flows two years post-decline from the year of decline

The table shows the changes in profitability and cash flow performance two years post-decline from the decline year. The post-decline performance is a two year average. For definitions of variables refer to Table 6.4. Sources: Datastream International and Extel Financial. The mean and median are tested using the t-test and the non-parametric Mann-Whitney Wilcoxon test. ***,**,* indicate significance at 1%, 5% and 10% respectively.

	Decline year Mean (%)	Average of two post decline years Mean (%)	t stat.	z stat.
Recovery firms				
PBIT/Sales	7.72	8.68	0.49	1.11
Earnings per share growth	-21.86	23.4	5.34***	4.46***
Return on equity	13.58	18.34	1.68*	2.25**
Return on assets	15.92	17.54	1.35	1.65*
PBITD/Capital employed	24.6	25	0.29	0.65
PBITD/Total Debt	60.84	112.84	5.39***	4.66***
Sample size	77			
Non-recovery firms				
PBIT/Sales	6.16	5.49	0.37	2.98***
Earnings per share growth	-31.39	-17.94	1.76*	1.03
Return on equity	12.43	6.08	1.75*	3.58***
Return on assets	13	7.99	3.56***	3.55***
PBITD/Capital employed	20.72	15.37	2.97***	2.80***
PBITD/Total Debt	43.11	52.8	1.26	0.56
Sample size	111			

In contrast, non-recovery firms register significant deterioration in four out of the six indicators tested. These firms continue to slide in performance measured in terms of PBIT/Sales, return on equity, return on asset and cash flow (PBITD) to capital employed. Earnings per share (EPS) growth continues to be negative. Debt cover (PBITD/Total debt) improves, although the improvement is insignificant⁴¹. The results further confirm the robustness of the recovery definition based on stock returns ranking for the poor performance sample.

6.6.2 Distressed firms

Sample characteristics

Table 6.10 provides the descriptive statistics for the sample. From Panel A, the mean (median) Z scores for the sample in the pre-distress and distress years are: 4.22 (3.61) (Distress year -2), 3.14 (2.17) (Distress year -1) and -1.86 (-1.25) (Distress year). The sample firms are clearly financially healthy in the pre-distress years. The steep decline is evident for each of the sample distress years 1985 to 1993.

A total of 55 distressed firms, or 27% of the sample, are also poorly performing between 1987-1993, and thus are included in the performing sample.

Panel B of Table 6.10 gives the performance statistics based on accounting variables. Profitability and cash flows deteriorate significantly in the distress year.

⁴¹The improvement appears to be a reflection of decline firms' pre-occupation with debt reduction.

Table 6.10: Descriptive statistics of sample firms financial performance:

Distressed sample

Panel A shows the sample firms' Z scores in the two years prior to and in the year of decline. Panel B shows percentage change in accounting based performance in the year of decline. PBIT = profit before interest and tax. Earnings per share (EPS) = profit after tax, minority interests and preference dividends but before extraordinary items / the average number of shares in issue in the year. Return on equity = profit attributable to shareholders / share capital and reserves less intangibles. Return on assets = profit before interest and tax / total assets less current liabilities. Size is the log of total assets at the beginning of the year of decline. In Panel B difference in means is tested using the t-test and the non-parametric Mann-Whitney Wilcoxon test. ***,**,* indicates significance at 1%, 5% and 10% respectively. Z score is supplied by Syspas Limited, London.

Panel A: Z score two years prior to, one year prior to and year of, distress

	No.	Z score in					
		Distress year-2		Distress year-1		Distress year	
		Mean	Med.	Mean	Med.	Mean	Med.
Total sample	201	4.22	3.61	3.14	2.17	-1.86	-1.25
Distress year, 1985	15	3.81	2.74	2.26	1.9	-1.62	-0.92
Distress year, 1986	16	4.72	4.67	3.52	2.77	-1.46	-1
Distress year, 1987	12	2.84	2.19	2.63	1.69	-2.21	-2.14
Distress year, 1988	28	4.54	4.52	2.79	2.01	-1.6	-1.28
Distress year, 1989	29	4.18	4.09	3.61	2.64	-2.07	-2
Distress year, 1990	30	5.21	4.16	4.13	2.17	-1.84	-1.35
Distress year, 1991	33	4.03	3.66	2.75	2.24	-1.99	-1.18
Distress year, 1992	25	3.32	2.67	2.62	2.14	-1.38	-1.06
Distress year, 1993	13	4.75	4.25	3.64	2.65	-2.97	-1.28

Panel B: Changes in financial performance measures in the year of distress

	Average of two pre-distress years Mean(%)	Decline year Mean (%)	t stat.	z stat.
PBIT/Sales	9.54	4.64	6.25***	7.22***
Earnings per share	35.94	-26.7	6.38***	5.65***
Return on equity	24.96	5.9	7.22***	7.06***
Return on assets	18.38	8.88	7.06*	7.36***
PBITD/Capital employed	14.2	3.37	8.14***	8.00***
PBITD/Total debt	74.39	6.36	12.72***	11.26***
			Mean	Median
Size (£M)			373.12	69.8

All six profitability and cash flow measures - operating margin (PBIT/sales), earnings per share growth, return on equity and return on assets, operating cash flow to capital employed (PBITD/Capital employed) and operating cash flow to total debt - register significant drops (at 1%, except return on assets) in terms of mean of the two pre-distress years' figures to the distress year. The univariate accounting ratios thus closely reflect the negative composite Z scores.

Agency monitoring mechanisms and turnaround strategies

Panel A of Table 6.11 provides descriptive statistics on the leverage, share ownership and governance structure in the pre-distress year. The median leverage, total book debt/book debt and equity, is 30%. This is similar to the 27% in a sample of 297 poorly performing firms examined earlier (Table 6.5). In the following discussion, comparative statistics from that sample are provided in parentheses. Median short term debt, bank debt and unsecured debt as proportions of book debt and equity are in the range 10% to 19% (12% to 16%).

Median directors' shareholding is 2.56% (9.5%) and associated block holding is again negligible. Median institutional ownership is 5.6% (6.9%). Non-institutional but unassociated blockholding has a median ownership of 0%, but a mean ownership of 3.8% (median 0%, mean 7%). Evidently, directors' shareholding and non-institutional unassociated block shareholding in distressed firms are lower than in merely poorly performing firms. The former may possibly be due to removal of incumbent shareholder-managers post-decline to poor performance - nearly 50% of managers are removed in the three-year period from and including the year of decline (see Table 6.6). The latter may be due to lack of institutional shareholder support for distressed firms. Indeed, institutional investors have been accused of cutting their losses and selling out on the first sight of financial trouble (Pound, 1988).

Table 6.11: Descriptive statistics for agency and restructuring strategy variables: Distressed sample

Panel A shows the descriptive statistics for the explanatory variables in the pre-distress year. For definitions of the variables see Tables 6.1 and 6.3. Panel B shows the distribution of corporate restructuring actions in the year of distress and over two years post-distress. In Panel A Chairman cum CEO, and Non-executive Chairmen are dummy variables coded as 1 when either is the case and 0 if otherwise. In Panel B frequency is the proportion of sample firm adopting the strategy. Sample size declines in Panel B due to failure of firm, takeover or where no data are available e.g. firms entering distress in 1993 (13 firms) are excluded from distress year+2 analysis.

Panel A: Descriptive statistics for agency variables

Agency variable	Pre-distress year	
	Mean	Median
<i>Capital structure</i>		
Leverage	0.31	0.30
Short term leverage	0.16	0.14
Bank leverage	0.21	0.19
Unsecured leverage	0.17	0.10
<i>Ownership structure (%)</i>		
Managerial shareholding	11.03	2.56
Associated block shareholding	1.33	0.00
Institutional block shareholding	11.96	5.60
Non-institutional unassociated block shareholding	3.82	0.00
<i>Governance structure</i>		
Chairman cum CEO	0.37	-
Non-executive Chairman	0.19	-
Outside directors	0.22	0.24

Table 6.11: Descriptive statistics for agency and dependent variables:

Distressed sample (Contd.)

Panel B: Descriptive statistics for control variables

	Mean		Median			
<i>Control variables</i>						
Internal cause of decline	0.30		-			
Severity of decline	10.8		10.9			
Size (£M)	344.2		54.8			
	Decline year		Decline year+1		Decline year+2	
	Mean	Med.	Mean	Med.	Mean	Med.
Economic condition	2.27	2.34	2.08	2.34	0.68	0.70
Industry condition	7.80	11.29	3.60	7.80	-32.75	-16.88

Panel C: Descriptive statistics for restructuring strategies in year of, first and second year post-distress.

	Distress year	Distress year+1	Distress year+2	Any of the three years
Sample size	201	191	166	166
Restructuring strategy	Frequency of sample firms undertaking strategy (%)			
<i>Operational restructuring</i>				
Costs rationalisation, closures and integration of business units	53.7	39.8	34.9	75.9
<i>Asset restructuring</i>				
Asset sales	35.8	43.4	41.6	66.3
Acquisition	49.3	31.9	30.1	60.8
Internal capital expenditure	53.7	49.2	42.8	62.6
<i>Managerial restructuring</i>				
Replace top management	32.8	28.8	25.9	67.5
<i>Financial restructuring</i>				
Equity issue	17.4	23.6	15.1	38.6
Dividend cut/omission	27.4	41.9	43.4	47.6
Debt restructuring	6.0	7.8	6.6	16.3
Cash generative actions	45.3	50.8	48.2	71.7

As regards board composition, in 37% (44%) of sample firms one person plays the dual roles of Chairman and CEO. Non-executive Chairmen preside over the board in 19% (24%) of the companies. The median proportion of outside directors in the sample boards is 22% (22%). Interestingly, both financial distress and poor performance firms suffer from low levels of outside directors' monitoring.

In the case of control variables, internal cause of distress is reported by management in 30% of sample firms. Economic and industry conditions appear to be reasonably good in the distress year, suggesting economic or industry condition is an unlikely cause of decline.

Panel C of Table 6.11 reports the frequencies of sample firms undertaking different turnaround strategies in the distress year and in the two post-distress years. Again, we find that the most frequent form of restructuring is operational with 54% of the sample firms undertaking it in the distress year and 40% and 35% of the firms in the two following years. Asset sales are carried out by between 35% and 43% of the firms in those years. Again, acquisitions do not cease when firms hit trouble and they are carried out by 49% of the sample firms in the distress year and by around 30% of the firms in the two post-distress years. Internal capital expenditure, again surprisingly, does not cease but is incurred by 54% of firms in the distress year and by 49% and 43% in the following years.

Replacement of top management is observed in 26% to 33% of the sample firms in the distress and post-distress years. Debt restructuring is quite infrequent

with only 6% of sample firms in the distress year and 8% and 7% in the following two years respectively taking recourse to it. Equity issues are made by 17% sample firms in the distress year climbing to 24% in the year after but decline to 15% in the third year. The most frequently employed financial restructuring device is dividend cut or omission. The proportions of firms adopting this strategy in the three years are: 27%, 42% and 43%.

Over the three-year period, from distress to two post-distress years, in excess of 75% of sample firms restructure their operations. About 72% of firms adopt cash generative actions - 66% sell assets and 39% make equity issues. Over 60% make acquisitions and internal capital expenditure. Nearly 68% of sample firms replace their Chairman or CEO in the three-year period. Just under half of sample firms resort to dividend cut/omission to stave off financial crisis. Finally, only 16% need to, or succeed in, restructuring their debts.

Comparison of restructuring strategies between poor performing and distressed samples

Table 6.12 shows the difference in proportions of firms in both samples adopting a particular restructuring strategy. In the year of performance decline significantly fewer distressed firms invest in capital expenditure than the poorly performing firms. In contrast, significantly more distressed firms sell their assets, sack their management or restructure their debts than the poorly performing firms.

Table 6.12: Restructuring strategy choice: A comparison between poorly performing and distressed samples

The table shows the difference in proportions of firms undertaking a strategy between poorly performing and distressed samples. The difference in proportions is tested for significance using the t-test. ***, **, * indicates significance at 1%, 5% and 10% respectively.

Restructuring strategy	Decline year			Decline year +1			Decline year +2		
	Poorly performing firms	Distressed firms	Difference in proportions	Poorly performing firms	Distressed firms	Difference in proportions	Poorly performing firms	Distressed firms	Difference in proportions
Operational	58.6	53.7	4.9	46.7	39.8	6.9	51.6	34.9	16.7***
Asset sales	26.6	35.8	-9.2**	37.8	43.5	-5.7	35.6	41.6	-5.9
Acquisitions	50.2	49.3	0.9	35.9	31.9	4.0	27.1	30.1	-3.0
Capital expenditure	61.6	53.7	7.9*	50.4	49.2	1.2	47.9	42.8	5.1
Managerial restructuring	19.5	32.8	-13.3***	25.9	28.8	-2.9	21.8	25.9	-4.1
Dividend cut/omission	23.6	27.4	-3.8	27.0	41.9	-14.8***	34.0	43.4	-9.3*
Equity issue	20.2	17.4	2.8	10.4	23.6	-13.2***	13.3	15.1	-1.8
Debt restructuring	2.4	6.0	-3.6*	3.3	7.9	-4.5**	7.4	6.6	0.8
Cash generative actions	40.1	45.3	-5.2	44.1	50.8	-6.7	43.6	48.2	-4.6
Sample size	297	201		270	191		188	166	

This trend is repeated in first and second year post-performance decline. In the first year post-decline/distress, significantly more distressed firms have to restructure their finances i.e. cut/omit dividends, raise equity issue and restructure their debt, than poorly performing ones. In the second year post-decline/distress, significantly more distressed firms have to cut/omit their dividends. However, in the second year, significantly more poor performing firms are beginning to restructure their operations than distressed ones.

Correlations among explanatory and control variables - Distressed sample

Table 6.13 reports the correlation matrix among the explanatory and control variables. Out of a total 105 pairwise correlations among 15 variables, only 7 equal or exceed 0.30 and 12 equal or exceed 0.20. The two largest correlations are between bank leverage and unsecured leverage (0.51), and bank leverage and short term leverage and (0.45). We shall concentrate our discussion on the five correlations in excess of 0.30.

As discussed earlier in section 6.6.1, the high positive relation between bank leverage and short term leverage is typical of UK firms. The high positive correlation between bank leverage and unsecured leverage is interesting, as it counters the typical assumption that all bank debts are secured in the UK.

Also, the high negative correlation between dual CEO and non-executive Chairman is expected (see Section 6.6.1).

Table 6.13 Pearson correlation coefficients among the explanatory and control variables: Distressed firms

The variables are defined in Table 6.3. Only values of 0.2 or greater are highlighted in bold.

Variable	1	2	3	4	5	6	7	8	9	10	11	12	13	14
1 Short term leverage														
2 Bank leverage	0.45													
3 Unsecured leverage	0.25	0.51												
4 Managerial shareholding	0.05	0.02	-0.17											
5 Institutional block shareholding	0.02	0.20	-0.01	-0.14										
6 Non-institutional unassociated block shareholding	-0.04	-0.06	-0.18	-0.06	-0.08									
7 Associated block shareholding	-0.08	-0.11	-0.12	-0.01	-0.06	-0.02								
8 Chairman cum CEO	0.05	-0.01	-0.03	0.04	-0.08	0.00	-0.09							
9 Non-executive Chairman	0.08	0.16	0.17	-0.15	0.21	-0.04	0.10	-0.37						
10 Proportion of outside directors	0.08	0.09	0.03	-0.09	0.04	0.00	0.00	0.00	0.20					
11 Economic condition	-0.01	-0.19	-0.22	0.17	-0.28	0.10	-0.02	0.02	-0.22	-0.14				
12 Industry condition	0.00	-0.13	0.00	-0.08	0.01	0.11	0.08	-0.14	0.05	0.20	0.22			
13 Internal problem	-0.11	-0.18	-0.15	0.07	-0.14	-0.08	-0.03	-0.03	-0.06	0.05	0.37	0.10		
14 Severity of decline	0.08	0.00	0.00	0.00	0.00	0.00	-0.05	-0.04	0.07	-0.03	0.01	-0.03	-0.02	
15 Size	-0.05	0.12	0.39	-0.30	-0.12	-0.10	-0.06	0.06	0.10	0.24	-0.30	-0.06	-0.15	-0.13

Economic condition is highly negatively correlated with an internal cause of decline, suggesting that when economic condition is good, financial distress is likely to be caused by an internal firm-specific problem. Finally larger firms tend to be associated with higher levels of unsecured leverage. This reflects larger firms' access to the wider source of finances such as the unsecured corporate bond market.

Collinearity, therefore, may not pose a problem in our regression models reported in the following chapters.. However, we shall run regressions based on simplified explanatory variables - one leverage variables i.e. total leverage, and two shareholding variables i.e. inside and outside shareholding, to ensure robustness of results and avoid potential multi-collinearity problems. As with the poor performing sample (Section 6.6.1), to test for the impact of lender and ownership types on restructuring strategy choice, we shall rerun all the regressions with the three lender types and four shareholder types described in Section 4.2.

Distressed firms' financial status two years post-distress

Table 6.14 shows the financial status of sample firms two years after distress. More than a third recover whilst nearly half of sample firms do not recover to their pre-distress performance (i.e. positive Z score), two years post-distress. The remainder of sample firms is either taken over (9.0%) or become insolvent (2.7%).

Table 6.14: Financial status two years after distress: Distressed sample

This table shows the sample firms' financial status two years post-distress. Two years after distress, firms may be taken over, become insolvent, recover, or remain in distress. Recovery is defined as the reversal to a positive Z score two years after distress. Firms that remain in negative Z score position are accordingly still in distress. Firms still in distress two years after distress (negative Z score) are called non-recovery firms. Sources: Syspas, Extel Financial and Datastream International.

Year	Taken over		Insolvent		Recovery		Non recovery		Total	
	No.	%	No.	%	No.	%	No.	%	No.	%
1985	3	20.0	-	-	9	60.0	3	20.0	15	8.0
1986	3	18.8	-	-	8	50.0	5	31.3	16	8.5
1987	-	-	-	-	9	75.0	3	25.0	12	6.4
1988	4	14.3	3	10.7	9	32.1	12	42.9	28	14.9
1989	5	17.2	-	-	11	37.9	13	44.8	29	15.4
1990	-	-	-	-	18	60.0	12	40.0	30	16.0
1991	2	6.1	1	3.0	17	51.5	13	39.4	33	17.6
1992	-	-	1	4.0	16	64.0	8	32.0	25	13.3
Total	17	9.0	5	2.7	97	51.6	69	36.7	188	100.0

The annual rate of recovery fluctuates between a low of 32% and a high of 75%. It is clear that firms that enter distress immediately prior to an economic downturn (distress years 1988-1989) have a much tougher turnaround job than do firms that enter distress in other economic conditions. The final sample comprises 166 recovery and non-recovery firms.

6.7 Conclusion

In this chapter we formulate logit and OLS regression models to reflect the relationship between restructuring strategy choice and agency monitoring framework and control variables, for both the poorly performing and distressed samples. For the poorly performing sample, the event study methodology to measure stock markets' assessment of the effectiveness of strategy implementation is discussed.

For both samples, we describe the criteria used to select sample firms and define the explanatory and dependent variables. We examine the characteristics of sample firms in terms of their financial performance, agency and control variables and choice of restructuring strategies.

The Pearson correlation coefficients among the explanatory variables indicate that only a few explanatory variables have high pairwise correlations terms, thus potentially mitigating any multi-collinearity in our regression models. The financial status two years post-decline are analysed, and the financial characteristics of recovery and non-recovery firms are contrasted. We also

compare the strategy choice between the poorly performing and distressed samples.

In the next chapter, we shall present and discuss the empirical results on the impact of lender, owner and governance structure on restructuring strategy choice, for the poorly performing sample. Also, in Chapter 8 we shall examine and discuss the results on the effectiveness of restructuring strategies for the poorly performing sample. In Chapter 9, we repeat the analyses in Chapter 7 and 8 for a sample of distressed firms.

Appendix 6.1: Event study methodology

Abnormal return

We define abnormal return AR_{it} as

$$AR_{it} = R_{it} - C_{it}$$

R_{it} is the continuously compounded (log) return on day t (dividend plus capital gains) for firm i . This is calculated as

$$R_{it} = \text{Log} \frac{P_{it} + D_{it}}{P_{i,t-1}}$$

P_{it} = Price of company i 's share at the end of trading on day t .

D_{it} = Dividends received on day t .

C_{it} = control rate of return which is what company i 's return would have been in the absence of the event. In order to ensure that our results are not sensitive to the models used in specifying the control rate of return, we use three alternative models to determine C_{it}

Model 1 : The market model

$$C_{it} = \alpha_i + \beta_i R_{mt} + \epsilon_{it}$$

where

R_{mt} = continuously compounded return on day t for the market index.

α_i = regression constant obtained from regressing R_{it} on R_{mt} . This measures the mean return over the estimation period which is not explained by the market.

β_i = regression co-efficient obtained from regressing R_{it} on R_{mt} .

ϵ_i = an error term with a mean of zero and a constant variance.

The values of α_i and β_i are obtained by regressing R_{it} on R_{mt} for the 150 trading days (if returns data are available) or fewer observations (with a minimum of 120 days) beginning at $t = -170$, where $t = 0$ is the event day.

Model 2 : The market adjusted model

The control rate of return for any firm in the event period⁴² is the return on the market index i.e. FT All Share Index, for that day.

$$C_{it} = R_{mt}$$

This model is equivalent to the market model where for all firms $\alpha_i = 0$ and $\beta_i = 1$.

Model 3 : The size adjusted model

Similar to Model 2 except that the control rate of return for any firm for a

⁴²Event period refers to the number of days over which abnormal returns centred on the event day are cumulated in order to estimate the impact of the event on shareholder wealth. In this thesis event period is -5 to +5 days centred on the strategy announcement date.

day in the event period is the mean daily return of firms in a similar-sized portfolio. Size portfolios are formed by ranking all companies listed in the Official, Unlisted and Third Market (until 1991) by year end market capitalisation. Size quintiles are formed with the lowest 20% given rank 1, next lowest 20% rank 2, and so on. Subsequent year equally weighted average returns of each quintiles are used as the size adjusted benchmark. Size quintile portfolios are then rebalanced every year.

Model 4 : The mean adjusted model

The control rate of return for any firm for a day in the event period is the mean daily return of the firm over the estimation period (ie, -170 to -21days centred on the event day).

$$C_{it} = \frac{\sum_{t=-170}^{t=-21} R_{it}}{150}$$

This model assumes that the expected return for company i is a constant but it can vary across firms. The model would be accurate if the risk free rate, risk premia and a company's systematic risk are constant over time.

Cumulative abnormal returns

For each day in the event period, the abnormal returns are averaged across

firms to produce the sample average abnormal return for that day AR_t .

$$AR_t = \frac{\sum_{i=1}^N AR_{it}}{N}$$

Where N is the number of firms in the sample.

The average cumulative abnormal returns (CAR) for N firms over a number of days from t_1 to t_2 is calculated by summing AR_t over the period from t_1 to t_2 .

$$CAR_{t_1,t_2} = \sum_{t=t_1}^{t=t_2} AR_t$$

The null hypothesis examined under the event study is that $AR_t = 0$ and $CAR_{t_1,t_2} = 0$. The test statistic under the null hypothesis is based on the assumption of cross-sectional dependence in the abnormal returns (Brown and Warner, 1985).

Test statistics assuming cross sectional dependence

The test statistic for event day t is

$$SAR_t^{DEP} = \frac{AR_t}{SD(AR)}$$

where

$$SD(AR) = \sqrt{\frac{\sum_{t=-170}^{t=-21} (AR_t - \overline{AR})^2}{149}}$$

and

$$\overline{AR} = \frac{\sum_{t=-170}^{t=-21} AR_t}{150}$$

For tests over the multi day interval t_1 to t_2 , the test statistic is

$$SCAR_{t_1, t_2}^{DEP} = \frac{CAR_{t_1, t_2}}{SD(AR) * \sqrt{t_2 - t_1 + 1}}$$

The problem of thin trading

The market model estimates of beta can be subject to a downward estimation bias if shares are thinly traded. In other words, price recorded at the end of a trading day for a security actually relates to a transaction occurring before that trading day. Dimson (1979) shows that the estimated betas of infrequently traded

securities rise as the returns measurement interval rises⁴³. This implies that when using daily returns the market model estimates of beta for thinly traded shares have a downward bias, while for frequently traded shares the bias is upward. Biased beta estimates will result in biased estimates of abnormal returns and consequently mis-specified results in an event study. A number of approaches have been suggested in the literature to correct for such thin trading bias (Scholes and Williams, 1977; Dimson, 1979; Fowler and Rourke, 1983).

Scholes and Williams (1977) show that under the assumption that a transaction takes place in every measurement interval (ie, a security does not have any missing observation between day -1 and +1) a consistent estimate of beta is

$$\beta_{SW} = \frac{\beta^{-1} + \beta^0 + \beta^{+1}}{1 + 2\rho_1}$$

where

β^{-1} = slope coefficient in a simple regression of R_{it} against $R_{m,t-1}$

β^0 = slope coefficient in a simple regression of R_{it} against $R_{m,t}$

β^{+1} = slope coefficient in a simple regression of R_{it} against $R_{m,t+1}$

ρ_1 = first order serial correlation of the market index.

The Dimson (1979) aggregated coefficient estimator does not require that a transaction take place in every measurement interval. The Dimson estimator is

⁴³ie, betas calculated using monthly returns are higher than betas calculated using daily returns for infrequently traded shares.

obtained by regressing the security return on day t against leading, synchronous and lagged returns of the market index, in order to obtain a set of slope coefficients, β_t which are then summed to give an unbiased estimate of true beta.

$$\beta_{DIM} = \sum_{t=-n}^n \beta_t$$

where β_t , $t = -n, \dots, 0, \dots, n$ are slope coefficients in an OLS regression of the return on the security in period t against the return on the market index in period $t-n, \dots, 0, \dots, t+n$.

Fowler and Rourke (1983) suggest a correction to the Dimson aggregated co-efficient method to equate it to the Scholes and Williams estimator. Fowler and Rourke show that when a security skips a single price observation, the correct beta estimate is

$$\beta_{FR} = \frac{\beta^{-2} + \beta^{-1} + \beta^0 + \beta^{+1} + \beta^{+2}}{1 + 2(\rho_1 + \rho_2)}$$

where

β^n = slope co-efficient in a simple regression of the security return in period t on the return on the market in period $t+n$.

ρ_1 = first order serial correlation coefficient of the market index.

ρ_2 = second order serial correlation coefficient of the market index.

The β_{FR} expression can be generalised for securities that skip two or more consecutive observations.

$$\beta_{FR} = \frac{\beta^{-n} + \beta^{-n+1} + \dots + \beta^0 + \beta^1 + \dots + \beta^n}{1 + 2(\rho_1 + \rho_2 + \dots + \rho_n)}$$

To correct for thin trading in this study, we tried the correction procedures suggested by Dimson (1979) and Fowler and Rourke (1983) using combinations of lead and lagged market return terms to represent from one to five missing transactions. This means one lead and one lag to test for one missing transaction (per Scholes and Williams / Fowler and Rourke) till five leads and five lags for five missing transactions. The results of five various combinations are compared below.

Number of			
Leads	Lags	Dimson	Fowler and Rourke
1	1	0.763	0.662
2	2	0.787	0.693
3	3	0.845	0.739
4	4	0.847	0.802
5	5	0.843	0.833

The final model was selected on the basis of maximum average sample beta - the Dimson correction procedure using four lags and four lead terms. The corrected betas in our sample is therefore 0.847.

Chapter 7. DETERMINANTS OF RESTRUCTURING STRATEGY CHOICE OF POORLY PERFORMING FIRMS: RESULTS OF EMPIRICAL ANALYSIS

7.1 Introduction

The objective of this chapter is to examine the relationship between agency monitoring and restructuring strategy choice. We report and discuss the impact of single stakeholder dominance on restructuring strategy choice. We employ logistic regressions to model the joint impact of lender types, ownership pattern and governance structure of poorly performing firms on their choice of restructuring strategies. The range of strategies explored and the explanatory variables employed are the most comprehensive of the turnaround studies to date. The results will contribute significantly to our knowledge of determinants of restructuring strategy choice in a turnaround context. In turn, an improved understanding of how turnaround strategy choice is determined contributes to improved turnaround management and success.

7.2 Impact of stakeholder dominance on turnaround strategy choice

As discussed in Section 6.2.2, we divide our sample into two groups - one stakeholder dominated and the other non-dominated by that stakeholder. For each stakeholder group - lenders, manager-owners, block shareholders, dual-CEO and collective board of directors - we examine the likelihood of a given strategy being

chosen. The difference in the proportions of sample firms in the dominated and non-dominated groups choosing a strategy is tested for statistical significance. Any significant difference reflects the influence of the dominant stakeholder.

Table 7.1 shows the proportions of sample firms pursuing a given strategy in the decline and two post-decline years when the differences in these proportions between dominant and non-dominant groups are significant. Sample firms are lenders dominated when their leverage is in the top quartile of all sample firms and they are in severe decline (bottom 50% in sample stock return ranking in the year of decline). Lenders under such circumstances are likely to have high stakes in recovery and to exercise their priority rights. Sample firms are manager dominated when they are not lenders dominated according to the above definition and the managerial and manager-associated shareholdings are in the top quartile of all sample firms.

Where neither lenders nor manager-owners are dominant according to the above definitions and the unassociated block shareholding is in the top quartile of all sample firms, the firms are deemed block shareholders dominated. Finally, when the sample firms not dominated by lenders, manager-owners and block shareholders, they are deemed to be under the control of the board of directors. In turn, the board may be dominated by a dual-CEO or collectively by the board members.

Comparison of predicted with actual impact of stakeholder dominance

The results in Panel A to E of Table 7.1 is summarised in Table 7.2. Table 7.2 also presents, for comparison purposes, the predicted impact of individual stakeholder dominance as discussed in Section 4.3 and presented in Table 4.2.

From Table 7.2, lenders dominated firms are more likely to opt for operational restructuring, cash generative actions (both asset sales and equity issues), dividend cut/omission and debt restructuring. They are less likely to approve of a cash-consuming strategy such as capital expenditure. The results show potential beneficial effects of lender monitoring. Lenders' insistence on operational restructuring, aimed at stopping 'the bleeding or cash haemorrhage', can be value-enhancing in the long run. Operational restructuring actions such as layoffs, closures and integration of facilities are often associated with large charges against earnings and cash outflow in the short term, but they can reduce costs and increase profitability and cash outflows in the long run.

On the other hand, lenders' tight financial reigns through discouraging investments can cause an under-investment problem. Lenders may not only be depriving firms of vital resources necessary to compete and reverse decline but also weaken their strategic health by favouring short term cash generative measures to facilitate debt repayment. Lenders' behaviour matches most predictions made in Table 4.2 except for the lack of influence in replacing top managers. Perhaps, sample firms' financial decline may not yet be severe enough to allow lenders to instigate top management changes.

Table 7.1: Stakeholder dominance restructuring strategy choice [Poor performance sample]

The choice of restructuring strategies is determined by the relative bargaining powers of various stakeholders in the firm. The table compares the choice of strategy between stakeholder dominated (Yes) and non-dominated (No) groups of declining firms. Five stakeholder groups are identified - lenders, owners, managers, blockholders, dual-CEO and board of directors. Where a firm is highly leveraged (i.e. top quartile of sample firms ranked on leverage) and has suffered a severe decline (bottom 50% of sample stock return ranking in the year of decline), lenders are deemed dominant in influencing the type of actions the firm takes. If the firm's decision making process is not dominated by lenders, and managerial and manager-associated shareholdings are high (i.e. top quartile of sample firms ranked on such shareholding), manager-owners are deemed to be entrenched and possess dominant influence. Where neither lenders nor manager-owners are dominant, and unassociated blockholding is high (i.e. top quartile of sample firms), ranked on such shareholding, relative to the total of all significant shareholdings, blockholders are deemed dominant. The remaining firms, which are not lenders, manager-owners or blockholders dominated, are deemed to be controlled by the board. The board is deemed to be dual-CEO dominated if Chairman is also the CEO and collectively dominated, if otherwise. The table shows the proportion of sample firms (prop) in each group choosing the strategy. Only strategies for which there is a significant difference between dominant and non-dominant groups are shown. Difference in proportions is tested using the non-parametric Mann-Whitney Wilcoxon test. ***, **, * indicates significance at 1%, 5% and 10% respectively.

Strategies	Panel A: Lender dominance									
	Year of decline			Year of decline+1			Year of decline+2			
	Yes Prop.	No Prop.	z	Yes Prop.	No Prop.	z	Yes Prop.	No Prop.	z	
Operational restructuring	0.72	0.56	1.94**	0.69	0.43	2.78***	0.47	0.53	0.59	
Asset sales	0.35	0.25	1.33	0.6	0.34	2.90***	0.37	0.35	0.13	
Capital expenditure	0.53	0.63	1.18	0.31	0.53	2.39**	0.33	0.51	1.73*	
Dividend cut/omission	0.44	0.2	3.44***	0.51	0.23	3.48***	0.37	0.34	0.33	
Equity issues	0.26	0.19	0.95	0.17	0.09	1.41	0.23	0.11	1.76*	
Debt restructuring	0.09	0.01	3.24***	0.17	0.01	4.87***	0.1	0.07	0.58	
Cash generative actions	0.49	0.39	1.27	0.69	0.4	3.13***	0.53	0.42	1.17	
Sample size	43	254		35	235		30	158		
Panel B: Manager-owner dominance										
Operational restructuring	0.41	0.63	3.13***	0.36	0.49	1.80*	0.5	0.52	0.24	
Asset sales	0.11	0.3	2.99***	0.19	0.43	3.33***	0.16	0.42	3.12***	
Acquisitions	0.36	0.54	2.47**	0.22	0.39	2.42**	0.23	0.28	0.75	
Capital expenditure	0.2	0.45	3.64***	0.22	0.5	3.74***	0.25	0.49	2.84***	
Managerial restructuring	0.15	0.21	1.05	0.16	0.29	2.04**	0.23	0.22	0.17	
Equity issues	0.1	0.23	2.26**	0.03	0.12	1.95*	0.11	0.14	0.43	
Sample size	61	236		58	212		44	144		

Table 7.1: Stakeholder dominance restructuring strategy choice [Poor performance sample] (Contd.)

Strategies	Year of decline		Year of decline+1		Year of decline+2	
	Yes	No	Yes	No	Yes	No
	Prop.	z	Prop.	z	Prop.	z
Panel C: Blockholder dominance						
Operational restructuring	0.55	0.51	0.59	0.33	0.5	2.34**
Asset sales	0.18	0.29	1.68*	0.28	0.4	1.71*
Capital expenditure	0.51	0.65	2.03**	0.4	0.53	1.81*
Sample size	65	232	60	210	28	160
Panel D: Dual-CEO dominance						
Capital expenditure	0.81	0.57	3.29***	0.67	0.46	2.58***
Managerial restructuring	0.18	0.2	0.42	0.16	0.28	1.85*
Dividend cut/omission	0.11	0.27	2.58**	0.19	0.29	1.32
Sample size	57	240	51	219	39	149
Panel E: Board dominance						
Operational restructuring	0.73	0.54	2.89***	0.5	0.46	0.62
Asset sales	0.38	0.23	2.9**	0.47	0.35	1.77*
Acquisitions	0.61	0.47	2.00**	0.47	0.32	2.15**
Cash generative actions	0.52	0.36	2.37**	0.53	0.42	1.68*
Sample size	71	226	66	204	47	141

Table 7.2: Impact of stakeholder dominance on restructuring strategy choice

The table shows the predicted and actual impact of individual stakeholder dominance on restructuring strategy choice. The predicted impact is discussed in Section 4.3 and presented in Table 4.3 while the actual impact is summarised from Table 7.1. The signs +, -, 0 denote 'favoured', 'resisted' and 'neutral' by the dominant stakeholder.

Generic strategies	Specific strategies	Dominant stakeholder group											
		Lender		Manager-owner		Dual-CEO		Blockholders		Board			
		Pred. impact	Actual impact	Pred. impact	Actual impact	Pred. impact	Actual impact	Pred. impact	Actual impact	Pred. impact	Actual impact		
Operational	Cost cutting, layoff, closures and integration of business	+	+	-	-	0	+	-	+	+	+		
		+	+	-	-	0	-	-	+	+	+		
		-	-	+	+	+	-	-	+	+	+		
Asset	Divestment	+	+	-	-	0	-	-	-	-	-		
		+	+	-	-	0	-	-	-	-	-		
		-	-	+	+	+	-	-	+	+	+		
Managerial	Investment	+	0	-	-	-	-	-	+	+	0		
		+	0	-	-	-	-	-	+	+	0		
		+	0	-	-	-	-	-	+	+	0		
Financial	Equity: Dividend cut/omission	+	+	-	-	0	-	-	-	-	0		
		+	+	-	-	0	-	-	-	-	0		
		-/+	+	-	-	0	-	-	+	+	0		
Combined	Debt: Restructure debt	+	+	-/+	0	0	-	-	-	-	0		
		+	+	-/+	0	0	-	-	-	-	0		
		+	+	-/+	0	0	-	-	-	-	0		
Cash generative	Cash generative	+	+	+/	0	0	-	-	-	-	+		
		+	+	+/	0	0	-	-	-	-	+		
		+	+	+/	0	0	-	-	-	-	+		

Alternatively, managers may be succeeding in 'buying-out' lenders through by undertaking cash generative actions aimed at debt repayment. It is worth noting that lenders' strong positive association with debt restructuring confirms our alternative prediction made in Section 4.3.1, in that the positive relation exists by construct as highly geared firms have a higher probability of debt restructuring.

Manager-owners dominated firms are more likely to undertake capital expenditure and less inclined to pursue operational restructuring, asset sales, acquisitions and equity issues. They are also less likely to sack their top management!. Dual-CEO dominant board influence is also limited.

Declining firms dominated by their dual-CEOs prefer capital expenditure but disfavour dividend cut/omission. Dominant dual-CEOs understandably reduce the chances of managerial restructuring. In summary, the behaviours of dominant owner-managers and dual role CEOs are similar to predictions made earlier, except for the lack of impact on debt restructuring. Perhaps, we have to look at the logistic regressions later in the chapter for pointers. It is interesting to note the preference for capital expenditure but not acquisitions by owner-manager dominated firms. However, in Table 6.7 we note that managerial shareholding (inherently high in owner-manager dominated firms) is negatively associated with size. Small firms, due to their size, are likely to go for internal capital expenditure rather than acquisitions.

When firms are dominated by blockholders, their influence is less pronounced and limited to three strategies. These shareholders make operational restructuring, asset sales and capital expenditure less likely. The actual impact is somewhat weaker than that predicted in Section 4.3. The resistance to operational

restructuring may be premised on the huge cost and ‘pain’ of operational restructuring. Frequently, restructuring costs outstrip operating profits in the restructuring year and cause a dent on the firms’ balance sheet value. Cash often has to be expended to meet redundancy and closure costs, putting pressure on cash flows available for dividends. A call for equity funds can be made imminent when large restructuring costs are incurred. Dominant block holders’ disfavour of divestments and investments are as predicted. However, the predicted impact on the other strategies such as resistance to equity issues and instigation of managerial restructuring is not observed. Again, we have to look at the logistic regressions later for pointers.

Collective board dominance influences only four strategies. With little conflict of interests in the board, operational restructuring, asset sales, acquisitions and cash generative actions are favoured by the board collectively. All the positive impacts are as predicted in section 4.3. However, the consensus nature of decision making means potentially controversial managerial restructuring is avoided. Again, we have to look at the logistic regressions later for pointers as to why there is a lack of influence on dividend cut/omission and debt restructuring.

Having explored the impact of stakeholder dominance on restructuring strategy choice, we examine the impact of individual agency monitoring mechanisms on strategy choice.

7.3 Impact of individual agency monitoring mechanisms on turnaround strategy choice: Logit regressions

Tables 7.3 to 7.5 report the model coefficients for the logistic regressions

of corporate restructuring strategy choices on the agency and control variables. A separate regression is run for each strategy and for each of the following years: year of performance decline (the decline year), the year after the decline year (decline year + 1) and the second year after the decline year (decline year + 2)⁴⁴.

We model the strategy choices in each year, rather than over a single period covering the three years, to examine whether there is a time lag in the incidence and impact of agency and control variables. It is plausible that certain drastic strategies like top managerial change or asset reduction may be undertaken after less controversial 'first measure' strategies such as operational restructuring.

7.3.1 Strategy choices and their determinants in the decline year

In the decline year, in Table 7.3, the logistic models are significant (based on the chisquare statistic at at least 10%) in all except where managerial restructuring, equity issues and debt restructuring are the dependent variables. Significance of the individual variables is tested for using the Wald statistic⁴⁵ The explanatory power of the models, measured by McFadden's R^2 , ranges from 4% to 24%.

It appears that in the decline year itself significant restructuring begins to take place and the impact of several agency and control variables is felt. Lenders increase the probability of cash generative actions such as asset sales, and debt restructuring. They, however, disfavour capital expenditure.

⁴⁴We have not pooled strategies over the three years as it would lose the impact of timing and sequence of strategies.

⁴⁵ To simplify the tables, the Wald statistic is not reported and only its level of significance indicated when it is significant at least at the 10% level.

Table 7.3: Logistic regression of restructuring strategies on agency and control variables: Decline year [Poor performance sample]

Coefficients of the logistic regressions of restructuring strategies on agency and control variables are presented. The dependent variable equals one if a strategy is adopted, and zero otherwise. For definitions of strategies see Table 6.1. The explanatory variables are based on pre-decline year's, except for economic and industry condition, which are based on current year's, figures. For definitions and descriptive statistics of the explanatory variables, see Tables 6.2 and 6.5. The sample consists of 297 declining firms over the period 1987 to 1993. The decline year refers to the year in which a firm declines to the bottom 20% ranking in stock returns, in the market, after having been in the top 50% for two previous consecutive years. Coefficients are tested for significance using the Wald test statistic. ***, **, * indicate significance at 1%, 5% and 10% respectively.

Model: Restructuring strategy = f(Debt, ownership, governance and control variables)

Explanatory variables	Operational			Capital			Managerial			Debt			Cash		
	restructuring	Asset sales	Acquisition	expenditure	restructuring	omission	Equity issues	restructuring	generation	restructuring	omission	Equity issues	restructuring	generation	
Leverage	0.63	2.84***	0.08	-1.76**	-0.86	0.45	1.10	4.63*	2.58***						
Inside shareholding	-0.02**	-0.02***	-0.02**	0.00	0.00	0.01	-0.01	-0.01	-0.02***						
Outside shareholding	-0.01	-0.02**	-0.01	-0.01	0.01	0.01	0.01	0.01	-0.01						
Chairman cum CEO	-0.36	-0.19	-0.21	0.71**	-0.09	-0.61	0.36	0.97	-0.58*						
Non-executive Chairman	-0.05	0.21	-0.19	0.24	-0.19	-0.69	-1.04**	0.11	-0.28						
Proportion of outside directors	1.45	0.49	0.21	1.78	-0.54	-0.36	0.11	0.63	-0.21						
Economic condition	-0.15**	0.13*	0.13**	0.22***	-0.13*	-0.50***	0.08	-0.18	0.13*						
Industry condition	-0.01	-0.01	0.00	-0.01**	0.00	-0.02**	0.00	-0.04*	-0.01						
Internal problem	1.12***	0.65**	-0.01	0.38	0.02	0.44	-0.39	-1.05	0.24						
Severity of decline	-0.05**	0.02	0.01	0.02	-0.07**	-0.12***	0.01	-0.13*	0.02						
Size	-0.10	0.08	0.07	-0.04	0.14	-0.30**	-0.12	-0.06	-0.05						
Constant	1.69**	-2.20**	-0.09	-0.13	-0.86	2.20**	-0.93	-3.92	-0.37						
McFadden's R-Square	12.1%	14.1%	5.9%	12.0%	4.4%	23.9%	5.3%	4.7%	13.0%						
Chi-square	38.20	45.25	18.00	38.10	13.30	81.20	16.26	14.20	41.20						
Regression p-value	0.00	0.00	0.08	0.00	0.27	0.00	0.13	0.22	0.00						

Inside shareholders significantly influence the choice of several strategies. They reduce the probability of the declining firm pursuing operational restructuring, cash generative actions such as asset sales, and cash-consuming acquisitions. Similar to inside shareholders, outside shareholders resist asset sales in the year of decline.

As regards the governance structure, declining firms with dual-CEOs are more likely to increase capital expenditure and reduce the probability of cash generative actions. Non-executive Chairmen make equity issues less likely. The proportion of outside directors on the board has little influence in the choice of turnaround strategy, at least in the decline year.

The control variables have varying impact on strategy choice. Where firm decline coincides with an economic downturn, firms react with several strategies. They resort to more operational restructuring, managerial restructuring and dividend cut/omission. However, cash generative actions such as asset sales, and investments are less likely during an economic downturn.

On the other hand, if the whole of their industry suffers decline, the sample firms are more likely to increase their capital expenditure perhaps to gain productivity improvements and competitive advantage, cut/omit their dividends and restructure their debts. Where decline has resulted from firm specific internal problems, operational restructuring is more likely.

The more severely declining firms (represented by low ranking on stock returns in the decline year) are more likely to go for operational restructuring, top

management replacement, dividend cut/omission and debt restructuring. Finally, large companies are more likely to avoid the need for dividend cut/omission.

In summary, lenders, shareholders and Chairman cum CEOs are active in the year of decline. Control variables such as economic condition, industry condition and severity of decline have a strong and almost dominant influence on the choice of restructuring strategy in the year of decline.

7.3.2 Strategy choices and their determinants: Year after decline

Strategy choice models for the second year of decline are shown in Table 7.4. All logit models are significant at better than the 5% level except for managerial restructuring. McFadden's R^2 ranges from 7% to 27% and for most of the models the explanatory power is much higher than with their counterparts in the decline year in Table 7.3. It appears that agency and control variables exercise their influence more strongly in the second year of decline suggesting delayed reaction to the onset of decline.

Unsurprisingly, lenders continue to press for cash generative actions, both asset sales and equity issues. They are also more likely to agree to debt restructuring.

Ownership continues to influence strategy choices in the second year. Inside shareholders decrease the probability of operational restructuring and cash generative actions such as asset sales. Thus, management-associated shareholders' resistance to these strategies in the decline year is reinforced in the second year.

Table 7.4: Logistic regression of restructuring strategies on agency and control variables: Decline year +1 [Poor performance sample]

Coefficients of the logistic regressions of restructuring strategies on agency and control variables are presented. The dependent variable equals one if a strategy is adopted, and zero otherwise. For definitions of strategies see Table 6.1. For detailed definitions and descriptive statistics of the explanatory variables, see Tables 6.2 and 6.5. The explanatory variables are based on pre-decline year's, except for economic and industry condition, which are based on current year's, figures. The sample consists of 270 declining firms which are neither insolvent (bankrupt) nor acquired, one year post decline, in the period 1987 to 1993. Coefficients are tested for significance using the Wald test statistic. ***, **, * indicate significance at 1%, 5% and 10% respectively.

Explanatory variables	<i>Model: Restructuring strategy = f(Debt, ownership, governance and control variables)</i>								
	Operational restructuring	Asset sales	Acquisition	Capital expenditure	Managerial restructuring	Dividend omission	Equity issue	Debt restructuring	Cash generation
Leverage	0.85	2.35***	0.81	-0.83	0.50	1.41	1.39	10.83**	2.27***
Inside shareholding	-0.02***	-0.01**	-0.01	0.01	-0.01	0.00	-0.02	-0.10**	-0.02**
Outside shareholding	-0.03***	-0.01	0.00	0.00	0.00	0.00	0.01	0.05	-0.01
Chairman cum CEO	0.07	-0.39	-0.04	0.60*	-0.87**	-0.36	0.32	-1.09	-0.49
Non executive Chairman	0.24	-0.93**	0.73*	0.61	-0.48	0.47	0.47	-7.36**	-0.91**
Proportion of outside directors	-0.14	2.99**	0.81	0.57	2.47*	0.27	0.06	2.43	3.35***
Economic condition	-0.52***	0.03	0.29***	0.31***	-0.07	-0.43***	-0.11	-0.55**	0.00
Industry condition	0.02**	0.00	0.01	0.00	0.00	-0.01**	0.03***	0.10**	0.01
Internal problem	0.38	0.56*	-0.47	-0.21	0.02	0.05	-0.27	-10.47	0.47
Severity of decline	-0.06**	-0.02	0.05*	0.02	-0.03	-0.12***	-0.04	-0.50**	-0.03
Size	-0.11	0.10	0.22**	0.30***	-0.10	-0.08	-0.18	0.84	0.03
Constant	2.60***	-1.38*	-3.20***	-2.46***	-0.04	0.84	-1.32	-7.86*	-0.46
McFadden's R-Square	26.5%	14.9%	14.0%	14.0%	6.8%	19.4%	7.1%	17.7%	16.5%
Chi-square	83.00	43.70	40.80	40.70	19.10	58.30	20.00	52.50	48.80
Regression p-value	0.00	0.00	0.00	0.00	0.05	0.00	0.04	0.00	0.00

Interestingly, inside shareholders resist debt restructuring. This is consistent with discussion in Section 4.3 that manager-owners would prefer not to restructure their firms' debts due to the heavy demands placed by lenders, in particular the instigation of management changes.

Outside shareholders make operational restructuring less likely, a behaviour observed earlier in the case where blockholders dominate the firm's decision making process (see discussion in Section 7.2).

CEO-duality continues to increase the chances of capital expenditure but, unsurprisingly, reduces the probability of managerial restructuring. Non-executive Chairmen make cash generative actions such as asset sales, and debt restructuring less likely but capital expenditure more likely. Non-executive Chairmen's behaviour is consistent with earlier discussion in Section 4.2.3, which suggests that they go along with managers on policy decisions and potentially perpetuate managerial entrenchment.

In the second year, the beneficial effects of outside directors' monitoring are felt. More outside directors mean greater chances of cash generative actions such as asset sales, and managerial restructuring. Outside directors' activism in the second year is in stark contrast to their passivity in the decline year.

The effects of economic downturn are equally significant in the second year. It continues to increase the probability of operational restructuring and dividend cut/omission. It also increases debt restructuring, but reduces the probability of investments.

Industry downturn makes operational restructuring, dividend cut/omission and debt restructuring more likely. However, the chances of successfully raising equity funds are much reduced. Reduction in equity issues during an industry downturn is comprehensible as the stock market may be less than enthusiastic about the prospects of firms in that industry. Internal cause of decline increases the need for asset sales in the second year of decline. Severity of decline impacts further in the second year. It continues to make operational restructuring, dividend cut/omission and debt restructuring more likely. In addition, the more severely declining firms are also less likely to undertake acquisitions. Finally, size increases the probability of investments in the form acquisitions and capital expenditure. This supports the discussion in Section 4.3 that large firms are more resourceful and therefore have the option of investing in more profitable products/markets to reverse their decline.

7.3.3 Strategy choices and their determinants: Second year after decline

The logit models of strategy choices made in the third year of decline (decline year + 2) are shown in Table 7.5. In contrast to the model for the previous year in Table 7.4, only five of the third year models are significant at least at 10% level. McFadden's R^2 ranges from 5% to 27%. The third year models thus generally have less explanatory power than the models for the first year after decline. It appears that the influence of the agency and control variables on strategy choices is waning. Nevertheless, some of these variables continue to exert significant impact.

Lenders continue to restrict capital expenditure. Debt restructuring is again made more likely by lenders. Inside shareholders stubbornly resist cash generative strategies, specifically asset sales, for the third consecutive year.

Table 7.5: Logistic regression of restructuring strategies on agency and control variables: Decline year +2 [Poor performance sample]

Coefficients of the logistic regressions of restructuring strategies on agency and control variables are presented. The dependent variable equals one if a strategy is adopted, and zero otherwise. For definitions of strategies see Table 6.1. For definitions and descriptive statistics of the explanatory variables, see Tables 6.2 and 6.5. The explanatory variables are based on pre-decline year's, except for economic and industry condition, which are based on current year's, figures. The sample consists of 188 declining firms which neither are insolvent (bankrupt) nor acquired, two years post decline. The sample covers only firms in decline in the period 1987 to 1992, as firms declining in 1993 have only one year post decline strategies to the end of the analysis period i.e. December 1994. Sample size is therefore reduced. Coefficients are tested for significance using the Wald test statistic. ***, **, * indicate significance at 1%, 5% and 10% respectively.

Explanatory variables	Model: $Restructuring\ strategy = f(Debt, ownership, governance\ and\ control\ variables)$								
	Operational restructuring	Asset sales	Acquisition	Capital expenditure	Managerial restructuring	Dividend omission	Equity issues restructuring	Debt restructuring	Cash generation
Leverage	-0.20	0.90	0.71	-1.96**	-0.24	1.19	2.08	3.36*	1.32
Inside shareholding	-0.01	-0.02**	0.00	0.00	0.01	0.00	0.00	-0.01	-0.02*
Outside shareholding	-0.01	-0.02	0.00	0.00	-0.01	0.02	-0.02	0.00	-0.02*
Chairman cum CEO	-0.54	-0.36	0.37	0.68*	0.05	-0.07	-0.33	0.56	-0.25
Non executive Chairman	0.07	-0.19	0.46	0.55	0.06	0.15	0.44	-0.18	0.19
Proportion of outside directors	0.55	2.45*	3.13**	2.55*	-0.24	0.57	2.93	-0.43	2.61*
Economic condition	-0.51***	0.05	0.22***	0.34***	-0.08	-0.31***	-0.06	0.07	-0.02
Industry condition	0.00*	-0.01***	0.00	0.00	-0.01***	-0.01***	0.00	-0.01*	0.00
Internal problem	0.81**	0.65*	-0.44	-0.16	0.07	-0.66	0.04	0.06	0.41
Severity of decline	-0.04	0.03	0.02	0.04	-0.02	-0.06*	0.02	0.00	0.03
Size	0.17	0.16	0.11	0.23	0.15	-0.15	-0.08	0.22	0.13
Constant	0.27	-1.88	-3.03***	-2.71	-1.86	-0.44	-2.55	-4.96***	-1.48
McFadden's R-Square	22.2%	15.0%	9.7%	19.3%	7.0%	27.2%	5.4%	5.4%	12.9%
Chi-square	47.10	30.55	19.20	40.20	13.60	59.80	10.58	10.60	25.90
Regression p-value	0.00	0.00	0.05	0.00	0.25	0.00	0.49	0.47	0.00

Outside shareholders also join inside shareholders in resisting cash generative strategies in the third year.

As regards governance structure, dual CEOs persist with their preference for capital expenditure for the third consecutive year. Non-executive Chairmen, however, are largely inactive. With more outside directors declining firms are more likely to undertake not only more cash generative actions such as asset sales, but also acquisitions and capital expenditure, perhaps to expand the firm after two years of restructuring.

The impact of external environment is still important in the third year. Economic downturn still increases the probability of operational restructuring and dividend cut/omission, and reduces the probability of acquisitions and capital expenditure. If the industry is depressed in the third year, sample firms would need to continue selling assets, cutting/omitting dividends and restructuring their debts. However, they are also inclined to remove their top management and restructure their operations. Presumably, where the external industry condition is unfavourable there is less need for firm specific remedial strategies, and hence operational restructuring is less likely. The converse can be said of favourable industry condition which renders any remedy for performance decline to be firm specific. Consequently, operational restructuring is more likely.

Sample firms are still constrained in their strategy by the existence of an internal cause of decline and severity of the initial decline. Firms with an internal cause of decline are still more likely to restructure their operations and make asset sales. Severe decline firms are still more likely to need dividend cut/omissions. Firm size, however, ceases to have any impact in the third year.

7.3.4 Strategy choices and their determinants: A three-year summary

Impact of agency monitoring mechanisms

Table 7.6 summarises the results of the logit models of turnaround strategy choice reported in Tables 7.3 to 7.5 and highlights the impact of each agency or control variable on the probability of choosing or avoiding different strategies.

In Table 7.7, a comparison between the predicted impact shown in Table 4.3 and the actual impact reported in Table 7.6 is presented. The following discussion refers to both Tables 7.6 and 7.7.

Lenders prefer cash generation and object to investments such as capital expenditure. This behaviour is as predicted earlier. However, lenders are also inclined to restructure their lending, confirming our alternative prediction made earlier. It suggests that a positive association exists rather by definition than choice as high leverage firms are bound to experience more debt restructuring than low leveraged ones.

Inside shareholders do not favour any strategy but disfavour operational and debt restructuring, acquisitions and cash generative actions. Again, this behaviour confirms earlier predictions in Section 4.3.2.

Outside shareholders appear to support inside shareholders in resisting operational restructuring and cash generative actions. The resistance to operational restructuring is unexpected as this strategy is most uncontroversial of the lot.

Table 7.6: Summary of the effect of each explanatory variable on the choice of restructuring strategies [Poor performance sample]

This table summarises the results in Tables 7.3 to 7.5. The multiple influences of each explanatory variable on the probability of various restructuring actions occurring are highlighted. Variables that are significantly positively(negatively) related to particular strategies [i.e. increasing(decreasing) the probability of those actions occurring] in the logistic regression models in Tables 7.3 to 7.5, are separately listed.

Explanatory variable	Probability of restructuring action	
	Increased	Decreased
Leverage	Asset sales Debt restructuring Cash generative actions	Capital expenditure
Inside shareholding		Asset sales Acquisitions Operational restructuring Debt restructuring Cash generative actions
Outside shareholding		Operational restructuring Asset sales Cash generative action
Chairman cum CEO	Capital expenditure	Managerial restructuring Cash generative actions
Non executive Chairman	Acquisitions	Asset sales Equity issues Debt restructuring Cash generative actions
Proportion of outside directors	Asset sales Acquisitions Capital expenditure Managerial restructuring Cash generative actions	
Economic downturn	Operational restructuring Dividend cut/omission Debt restructuring	Asset sales Acquisitions Capital expenditure Cash generative actions
Industry downturn	Capital expenditure Dividend cut/omission Managerial restructuring Debt restructuring	Operational restructuring Asset sales Equity issues Debt restructuring
Internal problem	Operational restructuring Asset sales	
Severe decline	Operational restructuring Managerial restructuring Dividend cut/omission Debt restructuring	Acquisitions
Size	Acquisitions Capital expenditure	Dividend cut/omission

Table 7.7 Predicted and actual impact of lenders, ownership and governance on restructuring strategy choice [Poor performance sample]

The table shows the predicted and actual impact of lenders, ownership and governance variables on restructuring strategy choice. The predicted impact is discussed in Section 4.3 and presented in Table 4.3 while the actual impact is from Table 7.6. The signs +, -, 0 denote 'favoured', 'resisted' and 'neutral' respectively.

Specific strategies	Lenders		Inside shareholders		Outside shareholders		Chairman cum CEO		Non-executive Chairman		Outside directors	
	Pred.	Actual	Pred.	Actual	Pred.	Actual	Pred.	Actual	Pred.	Actual	Pred.	Actual
Operational	+	0	-	-	+	-	-	0	-	0	+	0
Asset: Divestment (sales)	+	+	-	-	-	-	-	0	-	-	+	+
Investment Acquisitions	-	0	+	-	-	0	+	0	+	+	+	+
Capital expenditure	-	-	+	0	-	0	+	+	+	0	+	+
Managerial Top management changes	+	0	-	0	+	0	-	-	-	0	+	+
Financial: Dividend cut/omission	+	0	-	0	-	0	-	0	-	0	+	0
Equity issue	+	0	-	0	-	0	-	0	-	-	+	0
Debt restructuring	-	+	-	-	+	0	-	0	-	-	+	0
Cash generative	+	+	-	-	-	-	-	-	-	-	+	+

However, as discussed earlier in section 7.2 under blockholder dominance, this resistance to operational restructuring may be premised on the huge cost and ‘pain’ of operational restructuring. Briefly, cash is often expended to meet redundancy and closure costs, putting pressure on cash flows available for dividends.

Chairmen cum CEOs resist managerial restructuring and cash generative actions and favour capital expenditure. Again, this behaviour confirms our earlier prediction in Section 4.3.2.

The focus of dual CEOs appears to be ‘survival’ i.e. keep their jobs, spending to get out of trouble and resist attempts to downsize through cash generative asset sales.

Similarly, non-executive Chairmen resist cash generative actions and favour acquisitions. They also resist debt restructuring. Barring the absence of a few predicted associations, most of the tendencies are as predicted in section 4.3. A non-executive Chairman structure indeed reinforces managerial entrenchment and leads to managerial inertia.

Only outside directors do not disfavour any particular strategies, and favour both cash generating and cash-consuming actions, and more important, instigate managerial restructuring. Again, behaviour of outside directors matches earlier predictions. This lends support to the effectiveness of the governance structure characterised by a substantial independent director presence. This contrasts with lenders, who appear to be primarily concerned only with conserving or

augmenting the cash position of declining firms.

Impact of control factors

Declining firms react differently to deterioration in the business environment. To keep the following discussion simple, we focus only on economic (industry) downturn. However, an economic (industry) upturn will simply mean the reverse impact applies. Faced with an economic downturn, declining firms resort to operational restructuring, dividend cut/omission and debt restructuring. Cash generative actions, however, are also more difficult in depressed economic climates. With difficulty in raising funds, investments are also less likely in harsh economic conditions. In contrast, when their industry as a whole experiences a downturn, declining firms pursue capital expenditure, dividend cut/omission, managerial and debt restructuring. Operational restructuring, however, is less needed during an industry downturn. This may be due to the external cause of decline which may have little to do with the firms internal operational efficiency. Firms with an internal cause of decline are obviously more likely to restructure their operations. Firms facing a severe decline in performance resort to operational restructuring, dividend cut/omission, debt restructuring and a reduction in acquisitions. More interestingly, management replacement is also more likely in such firms. This suggests that top managers are able to fend off attempts to replace them until the firm's financial situation deteriorates perilously. Large firms, being more resourceful, are less likely to resort to dividend cut/omission and

are more able to afford investments.

7.3.5 Joint impact of explanatory variables on strategy choice: A three-year summary

Table 7.8 summarises the joint impact of one or more agency or control variables on the probability of choosing or avoiding a particular strategy. It answers the questions 'which factors make a given restructuring strategy more likely and which factors make it less likely?' and 'is there a coalition of stakeholders bearing on the adoption of a given strategy?'

None of the strategies is favoured by all the stakeholders. A striking feature of the results is that certain stakeholder groups seem to act in similar ways to reduce or increase the probability of certain restructuring actions.

Inside and outside shareholders jointly resist operational restructuring. However, the strategy is made imperative when the economy is facing a downturn and when the firm faces a severe decline associated with an internal cause. Industry downturn, however, means less pressure to restructure the firm's internal operations.

Asset sales are jointly resisted by both shareholders and non-executive Chairmen whilst lenders and outside directors combine to press for it. Bad industry condition and the existence of an internal problem also make asset sales more likely. However, poor economic condition means a poor market for asset sales.

Table 7.8: Joint impact of explanatory variables on individual restructuring strategy choice [Poor performance sample]

As explanatory variables collectively influence the choice of restructuring strategies, their combined impact on the choice of a specific restructuring strategy is summarised from the results reported in Tables 7.3 to 7.5. Explanatory variables that are significantly positively/negatively related to a specific strategy, in the logistic regression models in Tables 7.3 to 7.5, increase/decrease the probability of that action occurring.

Restructuring strategy	Explanatory variables	
	Probability increasing	Probability decreasing
Operational restructuring	Economic downturn Severe decline Internal problem	Inside shareholding Outside shareholding Industry downturn
Asset sales	Leverage Proportion of outside directors Industry downturn Internal problem	Inside shareholding Outside shareholding Non-executive Chairman Economic downturn
Acquisitions	Non-executive Chairman Proportion of outside directors Size	Inside shareholding Severe decline Economic downturn

Table 7.8: Joint impact of explanatory variables on individual restructuring strategy choice (contd.)

Restructuring strategy	Explanatory variables	
	Probability increasing	Probability decreasing
Capital expenditure	Chairman cum CEO Proportion of outside directors Industry downturn Size	Leverage Economic downturn
Managerial restructuring	Proportion of outside directors Economic downturn Industry downturn Severe decline	Chairman cum CEO
Dividend cut/omission	Economic downturn Industry downturn Severe decline	Size
Equity issues		Non-executive Chairmen Industry downturn
Debt restructuring	Leverage Economic downturn Industry downturn Severe decline	Inside shareholding Non-executive Chairman Industry downturn
Cash generation	Leverage Proportion of outside directors	Inside shareholding Outside shareholding Chairman cum CEO Non-executive Chairman Economic downturn

Similarly, Chairmen cum CEOs, non-executive Chairmen and outside directors jointly prefer investments. In the case of acquisitions, non-executive Chairmen and outside directors' preference for them is matched by inside shareholders' resistance to the same strategy. Large firms also favour acquisitions. However, a severe decline in performance and the existence of an economic downturn depress the incidence of acquisitions. In the case of capital expenditure, Chairmen cum CEO and outside directors' joint preference for it is opposed by lenders. Again, large firms tend to adopt a spending strategy, perhaps due to their slack resources. Spending on internal capital expenditure to improve internal efficiency is also made compelling when the industry is facing a downturn. However, an economic downturn reduces the likelihood of capital expenditure.

Managerial replacement is made more likely by outside directors, but it is, predictably, opposed by Chairmen cum CEOs. However, a case for changing firm leadership is enhanced when the firm faces a severe decline or when the economy or the industry is facing a downturn.

Only large firms appear to have the financial clout to avoid a dividend cut/omission. Similar to managerial restructuring, a case for dropping dividends is enhanced when the firm faces a severe decline or when the economy or the industry is facing a downturn.

As for equity issues, the chances of successfully raising funds via the stock market are reduced when the firm's industry sector is facing a downturn. Surprisingly, non-executive Chairmen, perhaps in support of owner-managers who

may suffer financially, appear to resist equity issues.

Inside shareholders and non-executive Chairmen jointly resist debt restructuring whilst lenders make it more likely. Firms facing a severe decline or an industry downturn are also more likely to restructure their debt. Industry downturn, however, appears to have mixed impact on debt restructuring.

Cash generative actions such as asset sales are favoured or opposed by different coalitions of interests. While bank creditors push for cash generative actions, they are supported by outside directors but the coalition of inside and outside shareholders, Chairman cum CEO and non-executive chairmen makes it less probable. Also, the existence of an economic downturn makes it less likely.

Our results thus reveal shifting coalitions of stakeholders vis a vis different turnaround strategies. The results based on logit regression models are largely consistent with those discussed earlier under stakeholder dominance (see Section 7.2) and thus add to the robustness of our conclusions about the impact of lenders, ownership and governance variables on restructuring strategy choice.

7.4 Impact of lender and ownership types on restructuring strategy choice

In our analysis so far we have, however, aggregated the different lender and shareholder types, for reason of mitigating any multi-collinearity problems. The question then is which type of lenders and owners favour which type of strategy. To test for the impact of these individual types, we rerun all the regressions in Tables 7.3 to 7.5 with three types of lenders instead of one, and four types of

shareholders instead of two. They are short term lenders, bank lenders and unsecured lenders, and manager shareholders, manager-associated block shareholders, institutional block shareholders and non-institutional unassociated block shareholders. To maintain clarity of presentation, only the summary results are shown in Tables 7.9 to 7.10. The results of the individual logit regressions are included as Appendices 7.1 to 7.3 to this chapter. The results must be interpreted with caution as we noted earlier in Section 6.7 that there exists significant correlations between certain leverage variables. Nevertheless, they contribute significant insight into the differing impact of individual types of lenders and shareholders on firms' strategy choice during periods of poor performance.

7.4.1 Impact of lender types

Table 7.9 summarises the effect of each explanatory variable on restructuring strategy choice shown in Appendices 7.1 to 7.3. The results show that short term and unsecured lenders press for operational restructuring. This is in contrast to the neutral impact of combined lenders on operational restructuring earlier.

Bank and short term lenders jointly press for cash generative actions. Unsecured lenders are also able to make dividend cut/omission more likely. However, only bank lenders have the clout to demand asset sales and restrict firms' capital expenditure.

Table 7.9: Summary of the effect of each explanatory variable on restructuring strategy choice: Individual variables [Poor performance sample]

This table summarises the results in Appendix 7.1 to 7.3. The multiple influences of each explanatory variable on the probability of various restructuring actions occurring are highlighted. Variables that are significantly positively/negatively related to particular strategies (i.e. increasing/decreasing the probability of those actions occurring) in the logistic regression models in Appendix 7.1 to 7.3, are separately listed.

Explanatory variable	Probability of restructuring action	
	Increased	Decreased
Short term leverage	Operational restructuring Cash generative actions	
Bank leverage	Asset sales	Capital expenditure
Unsecured leverage	Cash generation Operational restructuring Dividend cut/omission	
Managerial shareholding		Operational restructuring Asset sales Acquisitions Cash generative actions
Institutional shareholding		Operational restructuring Asset sales Cash generative actions
Non-institutional unassociated shareholding	Managerial restructuring Dividend cut/omission	Operational restructuring Asset sales Cash generative actions
Manager-associated shareholding	Acquisitions Managerial restructuring	
Chairman cum CEO	Capital expenditure	Managerial restructuring Cash generative actions

Table 7.9: Summary of the effect of each explanatory variable on restructuring strategy choice: Individual variables [Poor performance sample] (Contd.)

Explanatory variable	Probability of restructuring action	
	Increased	Decreased
Non executive Chairman	Acquisitions	Asset sales
	Capital expenditure	Cash generative actions
Proportion of outside directors	Asset sales	
	Acquisitions	
	Capital expenditure	
	Managerial restructuring	
	Cash generative actions	
Economic downturn	Operational restructuring	Asset sales
	Managerial restructuring	Acquisitions
	Dividend cut/omission	Capital expenditure
		Cash generative actions
Industry downturn	Capital expenditure	Operational restructuring
	Dividend cut/omission	Equity issues
	Managerial restructuring	
	Debt restructuring	
Internal problem	Operational restructuring	Dividend cut/omission
	Asset sales	(decline year + 2)
	Cash generative actions	
Severe decline	Operational restructuring	Acquisitions
	Managerial restructuring	
	Dividend cut/omission	
Size	Acquisitions	Operational restructuring
	Capital expenditure	Dividend cut/omission

7.4.2 Impact of ownership types

Manager shareholders resist operational restructuring, cash generative (including asset sales) and acquisition strategies. Conversely, manager-associated block shareholders prefer acquisitions and surprisingly, in a show of independence, managerial restructuring. Institutional block shareholders and non-institutional unassociated block shareholders ie. outside shareholders, jointly resist operational restructuring and cash generative actions such as asset sales. However, non-institutional block shareholders also make managerial restructuring more likely. They are also supportive of declining firms, in terms of accepting the need for dividend cut/omission.

7.4.3 Resulting impact on other agency and control variables

It is also interesting to note the impact of other agency and control variables on strategy choice resulting from replacing the combined lender and ownership variables with their individual components⁴⁶. The individual impact of dual CEO and outside directors is similar. In the case of non-executive Chairmen, their previous negative association with equity issues and debt restructuring is lost.

The impact of external environment is largely the same. The exceptions are economic downturns which make managerial and not debt restructuring more likely, and the previous negative association between industry downturn and asset

⁴⁶This is not strictly true for lenders as short, bank and unsecured lenders are not mutually exclusive.

sales and debt restructuring is now lost. The existence of an internal problem now additionally and strangely reduces the probability of a dividend cut/omission (in the third year of decline). Severe decline no longer makes debt restructuring more likely and large firm size now makes operational restructuring less likely.

7.4.4 Resulting impact on coalitions of stakeholders

With a few exceptions, the joint impact or coalitions of agency variables bearing on the adoption of a given strategy, shown in Table 7.10, is broadly similar to earlier results generated from combined lender and ownership variables.

Lenders, short and unsecured, are now observed to press for operational restructuring. Manager-associated shareholders favour acquisitions and non-executive Chairmen support capital expenditure. Non-institutional unassociated shareholders and, surprisingly in a show of independence, manager-associated shareholders join outside directors to demand managerial restructuring. Unsecured lenders' demand for dividend cut/omission is supported by non-institutional unassociated shareholders. Non-executive Chairmen no longer influences equity issue decisions, and so are lenders with respect to debt restructuring.

Table 7.10: Joint impact of explanatory variables on individual restructuring strategy choice: Individual variables [Poor performance sample]

As explanatory variables collectively influence the choice of restructuring strategies, the combined impact of explanatory variables on the choice of a specific restructuring strategy is summarised from the results reported in Appendix 7.1 to 7.3. Explanatory variables that are significantly positively/negatively related to a specific strategy, in the logistic regression models in Appendix 7.1 to 7.3, increase/decrease the probability of that action occurring.

Restructuring strategy	Explanatory variables	
	Probability increasing	Probability decreasing
Operational restructuring	Short term leverage	Managerial shareholding
	Unsecured leverage	Institutional shareholding
	Economic downturn	Non-institutional
	Severe decline	unassociated shareholding
	Internal problem	Industry downturn
		Size
Asset sales	Bank leverage	Managerial shareholding
	Proportion of outside directors	Institutional shareholding
	Internal problem	Non-institutional
		unassociated shareholding
		Non-executive Chairman
		Economic downturn
Acquisitions	Manager-associated shareholding	Managerial shareholding
	Non-executive Chairman	Severe decline
	Proportion of outside directors	Economic downturn
	Size	

Table 7.10: Joint impact of explanatory variables on individual restructuring strategy choice: Individual variables [Poor performance sample]

Restructuring strategy	Explanatory variables	
	Probability increasing	Probability decreasing
Capital expenditure	Chairman cum CEO Non-executive Chairman Proportion of outside directors Industry downturn Size	Bank leverage Economic downturn
Managerial restructuring	Non-institutional unassociated shareholding Manager-associated shareholding Proportion of outside directors Economic downturn Industry downturn Severity of decline	Chairman cum CEO
Dividend cut/omission	Unsecured leverage Non-institutional unassociated shareholding Economic downturn Industry downturn Severity of decline	Internal problem Size
Equity issues		Industry downturn
Debt restructuring	Industry downturn	
Cash generation	Short term leverage Bank leverage Proportion of outside directors Internal problem	Managerial shareholding Institutional shareholding Non-institutional unassociated shareholding Chairman cum CEO Non-executive Chairman Economic downturn

7.5 Summary and conclusions

Firms which experience performance decline may choose a variety of alternative methods of restructuring themselves to restore their financial health. These restructuring strategies for poorly performing companies include operational, asset, financial and managerial restructuring. However, any restructuring strategy has different, and often conflicting, welfare implications for the different stakeholders in firms - shareholders, lenders and managers. Within the agency model of the firm the strategy choices made by managers may benefit one group of stakeholders at the expense of the other groups. However, managerial choices are also constrained by the agency monitoring embodied in the firms. Agency monitoring may be derived from the rights of lenders, the power and influence of large block shareholders or in the oversight function and independence of the board of directors. The choice of recovery strategies is, therefore, determined by the complex interplay of the ownership structure, corporate governance and lender monitoring of the firms in decline.

For a sample of 297 poorly performing firms, we examine the impact of agency monitoring and control variables on restructuring strategy choice. Our results show that turnaround strategy choices are significantly influenced by both agency variables and control variables. While there is agreement among stakeholders on certain strategies there is also evidence of conflict of interests between lenders and managers and between managers and some block shareholders. Lenders' preference for cash generative actions is in direct conflict

with shareholders' preference. Weak governance structure helps entrench managers and perpetuate their self-serving behaviour resulting in less restructuring particularly top management replacement. Non-institutional rather than institutional shareholders appear to be active monitors and influential in instituting top management changes. However, all types of shareholders disfavour any type of costly strategy such as operational restructuring or option value-destroying strategies such as asset sales. Boards of directors, however, seem to be effective in their oversight of managers, as they intensify adoption of turnaround strategies. There is evidence of shifting coalitions between lenders and directors in the choice of recovery strategies. Institutional shareholders generally seem to go along with management shareholders. Response of non-executive Chairmen and CEO cum Chairman to turnaround is broadly similar.

The results also show the effects of dominance by certain stakeholder groups. Dominant lenders instigate operational restructuring, cash generative actions, dividend cut/omission and debt restructuring. They are less likely to approve of a cash-consuming strategy such as capital expenditure. The results show potential beneficial effects of lender monitoring as lenders' insistence on operational restructuring, aimed at 'stopping the bleeding' or 'avoiding cash haemorrhage', can be value-enhancing in the long run. However, lenders' tight financial reins through wholesale ban on investments can cause an under-investment problem. Lenders may not only be depriving firms of vital resources necessary to compete and reverse decline but also jeopardising their long-term

health by favouring short term cash generative measures to facilitate debt repayment. It raises the question if banks are too keen to pull the plug on ailing firms which lack short term cash generation ability in spite of their healthy long term potential. Entrenched managers appear to be resistant to change in the wake of performance decline. Their refusal to remove themselves, restructure operations, cut dividends and support cash generative actions may lead a downward spiral to failure. They also tend to spend scarce resources in internal capital expenditure and hope to grow out of their predicament. Blockholders have a weak influence on a limited range of turnaround strategies. They disfavour costly operational restructuring, cash consuming and cash generative actions. However, board of directors not dominated by dual CEOs do intensify restructuring including managerial restructuring. Potentially, corporate failures can be explained by poor agency monitoring during decline, resulting in a low appetite for appropriate turnaround strategies.

Appendix 7.1: Logistic regression of restructuring strategies on agency and control variables: Decline year [Individual variables]

Coefficients of the logistic regressions of restructuring strategies on agency and control variables are presented. The dependent variable equals one if a strategy is taken, and zero if otherwise. The sample consists of 297 declining firms over the period 1987 to 1993. The decline year refers to the year in which a firm declines to the bottom 20% ranking in stock returns, in the market, after having been in the top 50% for two previous consecutive years. Coefficients are tested for significance using the Wald test statistic. ***, **, * indicate significance at 1%, 5% and 10% respectively.

Model: $Restructuring\ strategy = f(Debt, ownership, governance\ and\ control\ variables)$

Explanatory variables	Operational		Capital		Managerial		Dividend		Equity		Debt		Cash	
	restructuring	Asset sales	Acquisitions	expenditure	restructuring	cut/omission	restructuring	issues	restructuring	generation	restructuring	generation	restructuring	generation
Short term leverage	1.68	1.06	-0.73	0.36	1.00	0.77	0.49	2.60*	1.39	1.39	1.39	1.39	1.39	2.60*
Bank leverage	-0.96	1.95*	0.09	-1.91*	-1.96	-0.53	0.93	1.55	1.99	1.99	1.99	1.99	1.99	1.55
Unsecured leverage	3.02***	0.37	1.38	1.35	0.35	2.41*	0.07	0.19	3.13	3.13	3.13	3.13	3.13	0.19
Managerial shareholding	-0.02**	-0.02**	-0.02**	0.00	0.00	0.00	-0.02	-0.03***	-0.02	-0.02	-0.02	-0.02	-0.02	-0.03***
Institutional shareholding	-0.01	-0.03**	-0.02	0.00	0.00	-0.01	0.00	-0.03**	0.00	0.00	0.00	0.00	0.00	-0.03**
Non-institutional	-0.02*	-0.02	-0.01	-0.01	0.02*	0.02*	0.02	-0.01	0.01	0.01	0.01	0.01	0.01	-0.01
Manager-associated	-0.01	-0.09	0.00	-0.01	-0.04	-0.07	0.01	-0.03	0.03	0.03	0.03	0.03	0.03	-0.03
Chairman cum CEO	-0.40	-0.29	-0.16	0.79***	-0.06	-0.57	-0.37	-0.68**	0.68	0.68	0.68	0.68	0.68	-0.68**
Non executive Chairman	0.02	-0.06	-0.14	0.44	-0.11	-0.79	-1.14	-0.45	-0.68	-0.68	-0.68	-0.68	-0.68	-0.45
Proportion of outside	1.36	0.79	0.16	1.59	-0.61	-0.03	0.19	-0.04	1.07	1.07	1.07	1.07	1.07	-0.04
Economic condition	-0.15**	0.12*	0.13**	0.23***	-0.13*	-0.50***	0.07	0.13*	-0.25	-0.25	-0.25	-0.25	-0.25	0.13*
Industry condition	-0.01	0.00	0.00	-0.02**	0.00	-0.02**	0.00	0.00	-0.03	-0.03	-0.03	-0.03	-0.03	0.00
Internal problem	1.07***	0.65**	-0.02	0.30	-0.08	0.32	-0.36	0.21	-1.01	-1.01	-1.01	-1.01	-1.01	0.21
Severity of decline	-0.05**	0.02	0.01	0.02	-0.06**	-0.12***	0.01	0.02	-0.13	-0.13	-0.13	-0.13	-0.13	0.02
Size	-0.20*	0.07	0.01	-0.10	0.10	-0.46***	-0.13	-0.05	-0.19	-0.19	-0.19	-0.19	-0.19	-0.05
Constant	1.82**	-1.73**	0.07	-0.41	-0.68	2.83***	0.68	-0.14	-2.51	-2.51	-2.51	-2.51	-2.51	-0.14
Mcfadden's R-Square	15.7%	13.6%	6.8%	11.8%	5.4%	26.8%	6.3%	14.1%	4.8%	4.8%	4.8%	4.8%	4.8%	14.1%
Chi-square	58.90	43.40	20.90	37.50	16.40	92.50	19.29	45.20	14.50	14.50	14.50	14.50	14.50	45.20
Regression p-value	0.00	0.00	0.13	0.00	0.35	0.00	0.20	0.00	0.49	0.49	0.49	0.49	0.49	0.00

Appendix 7.2: Logistic regression of restructuring strategies on agency and control variables: Decline year+1 [Individual variables]

Coefficients of the logistic regressions of restructuring strategies on agency and control variables. The dependent variable equals one if a strategy is taken, and zero if otherwise. The sample consists of 270 declining firms which are neither insolvent (bankrupt) nor acquired, one year post decline, in the period 1987 to 1993. Coefficients are tested for significance using the Wald test statistic. **, *, indicate significance at 1%, 5% and 10% respectively.

Model: Restructuring strategy = f(Debt, ownership, governance and control variables)

Explanatory variables	Operational restructuring	Asset sales	Acquisitions	Capital expenditure	Managerial restructuring	Dividend cut/omission	Equity issues	Debt restructuring	Cash generation
Short term leverage	3.06*	0.69	0.23	2.09	-0.06	2.22	0.84	20.94	0.39
Bank leverage	-0.73	2.60**	1.83	-2.20*	0.73	0.48	-1.13	1.07	2.46**
Unsecured leverage	0.71	0.35	0.04	0.21	0.93	-1.32	1.89	8.16	0.45
Managerial shareholding	-0.02***	-0.02**	0.00	0.01	-0.01	0.01	-0.02	-0.16	-0.02***
Institutional shareholding	-0.03**	-0.02	0.01	-0.01	0.00	0.01	0.01	0.74	-0.01
Non-institutional	-0.03**	-0.01	-0.01	0.00	-0.01	0.00	-0.01	0.00	-0.01
Manager-associated	0.10	0.02	-0.13	0.02	-0.04	0.01	-0.05	-0.58	0.00
Chairman cum CEO	0.00	-0.39	-0.03	0.62*	-0.89**	-0.55	0.17	-0.95	-0.53
Non executive Chairman	0.33	-1.07***	0.68*	0.73*	-0.49	0.33	0.43	-18.73	-1.04***
Proportion of outside	-0.14	3.14**	0.90	0.46	2.50*	0.19	-0.19	22.75	3.49***
Economic condition	-0.54***	0.04	0.33***	0.31***	-0.07	-0.48***	-0.14	-4.65	0.00
Industry condition	0.02**	0.03	0.01	-0.01	0.00	-0.01**	0.03***	0.28	0.01
Internal problem	0.31	0.64**	-0.50	-0.33	0.02	0.08	-0.32	-20.54	0.55*
Severity of decline	-0.07**	-0.02	0.05*	0.02	-0.03	-0.13***	-0.04	-2.40	-0.03
Size	-0.12	0.11	0.25**	0.29**	-0.13	0.04	-0.18	6.16	0.04
Constant	2.54***	-1.28	-3.61***	-2.56***	-0.08	0.68	-1.02	-41.53	-0.41
McFadden's R-Square	29.1%	16.7%	16.5%	15.2%	7.8%	19.9%	7.9%	22.00	17.4%
Chi-square	92.70	49.40	48.70	44.40	21.80	60.10	22.39	67.10	51.60
Regression p-value	0.00	0.00	0.00	0.00	0.11	0.00	0.09	0.00	0.00

Appendix 7.3: Logistic regression of restructuring strategies on agency and control variables: Decline year+2 [Individual variables]

Coefficients of the logistic regressions of restructuring strategies on agency and control variables. The dependent variable equals one if a strategy is taken, and zero if otherwise. The sample consists of 188 declining firms which are neither insolvent (bankrupt) nor acquired, two years post decline. The sample covers only firms in decline in the period 1987 to 1992, as firms declining in 1993 have only one year post decline strategies to the end of the analysis period i.e. December 1994. Sample size is therefore reduced. Coefficients are tested for significance using the Wald test statistic. ***, **, * indicate significance at 1%, 5% and 10% respectively.

Model: $Restructuring\ strategy = f(Debt, ownership, governance\ and\ control\ variables)$

Explanatory variables	Operational restructuring	Asset restructuring sales	Acquisitions expenditure	Capital restructuring	Managerial restructuring	Dividend cut/omission	Equity issues	Debt restructuring	Cash generation
Short term leverage	-0.75	1.14	-0.34	-1.36	1.26	2.15	1.52	2.47	0.89
Bank leverage	0.71	1.06	-1.32	-2.47*	0.08	-1.48	-0.09	2.20	1.31
Unsecured leverage	0.03	-0.02	1.82	0.94	0.07	2.38*	1.94	-0.32	0.87
Managerial shareholding	-0.01	-0.02**	0.00	0.01	0.00	0.00	0.00	-0.01	-0.02
Institutional shareholding	-0.01	-0.01	0.01	0.02	-0.02	0.02	0.01	0.03	-0.01
Non-institutional	-0.01	-0.02*	-0.01	-0.01	-0.01	0.02	-0.04	-0.03	-0.03**
Manager-associated	0.02	-0.01	0.08*	0.01	0.16*	-0.02	-0.93	-0.02	-0.03
Chairman cum CEO	-0.49	-0.45	0.27	0.67*	0.07	-0.23	-0.59	0.29	-0.39
Non executive Chairman	0.10	-0.24	0.55	0.76	0.22	0.10	0.24	-0.32	0.12
Proportion of outside	0.50	2.52	2.87*	2.43*	-0.53	0.69	2.89	0.39	2.71*
Economic condition	-0.50***	0.03	0.21**	0.35***	-0.08	-0.35***	-0.13	0.00	-0.05
Industry condition	0.00*	-0.01	0.00	0.00	-0.01**	-0.02***	0.00	-0.01*	0.00
Internal problem	0.87**	0.73**	-0.43	-0.17	0.17	-0.86*	0.05	0.14	0.49
Severity of decline	-0.04	0.02	0.01	0.04	-0.02	-0.05	0.01	-0.02	0.03
Size	0.14	0.20	0.10	0.23	0.17	-0.18	-0.03	0.38	0.16
Constant	0.29	-2.18	-2.87**	-2.99**	-2.18*	-0.41	-2.62	-5.38***	-1.77*
McFadden's R-Square	22.49%	16.1%	13.4%	21.9%	10.38%	28.89%	7.9%	6.58%	15.20%
Chi-square	47.90	32.95	27.00	46.60	20.50	64.10	15.50	12.80	31.00
Regression p-value	0.00	0.00	0.02	0.00	0.15	0.00	0.41	0.61	0.00

Chapter 8. EFFECTIVENESS OF RESTRUCTURING STRATEGIES BY POORLY PERFORMING FIRMS: RESULTS OF EMPIRICAL ANALYSIS.

8.1 Introduction

In the previous chapter, we find that agency monitoring and control variables exert significant impact on management's choice of restructuring strategies. What then are the consequences of adopting those strategies? Are they effective, and are they instrumental to corporate recovery from performance decline?

In this chapter, we test for the difference in choice, timing, and intensity of restructuring strategies between recovery and non-recovery firms for pointers to what drives recovery. We also examine the shareholder wealth impact of strategy announcement, and use it to proxy for stock market perceived effectiveness of a strategy. Effectiveness of a strategy is a function of the appropriateness of the strategy choice, its timing, intensity and success of implementation. Therefore, from the wealth impact of a strategy announcement and its choice, timing, and intensity, we can infer the stock markets' perception of the implementation success.

We also employ a complementary method based on logit and OLS regressions of recovery on intensity of restructuring strategies to test for the effectiveness of those strategies in delivering recovery.

The results will contribute significantly to the extant knowledge of the

effectiveness of generic strategies prescribed in the literature (see Chapter 5). For corporate managers undertaking turnarounds our results will identify those strategies which are effective, and shed light on the turnaround process which distinguishes failed from successful turnarounds. Turnaround process in this context encompasses adopting the right strategy, and implementing it timely, intensively and successfully.

8.2 Financial characteristics of recovery and non-recovery firms

As defined earlier in Section 6.2.4, recovery is measured by the return by the poor performing firm to the top 50% in two year cumulative stock returns ranking in the market. The final sample for the purpose of examining the effectiveness of strategies consists of 188 firms which are not taken-over or insolvent, and have two complete years of post restructuring data (see Section 6.6.1).

Table 8.1 shows difference in stock returns, profitability and cash flows between the recovery and non-recovery firms in the pre-decline, decline and post-decline period. Panel A of Table 8.1 shows the raw log returns in the two years prior to decline and the decline year, and the profitability and cash flows in the decline year for the recovery and non-recovery firms. Non-recovery firms significantly outperform their recovery counterparts in stock returns in the two years prior to decline whilst they underperform the latter by a significant margin in the decline year.

**Table 8.1 Financial characteristics of recovery and non-recovery firms
[Poor performing sample]**

This table shows the financial performance of recovery and non-recovery firms before and after decline, and their size and risk characteristics. The mean difference is tested using the t-statistics and the non-parametric Mann-Whitney Wilcoxon tests. ***, **, * indicate significance of 1%, 5% and 10% respectively.

Panel A: Pre-decline and decline year performance

	Recovery firms	Non-recovery firms		
Sample size	77	111		
	Mean (%)	Mean (%)	t-stat.	z stat.
<i>Stock performance</i>				
Annual stock returns in decline year-2	34.14	45.7	2.50**	2.17**
Annual stock returns in decline year-1	29.4	37.3	1.94*	1.36
Annual stock returns in decline year	-51.1	-60.7	1.55	2.12**
<i>Profitability and cash flows in the decline year</i>				
PBIT/Sales	-24.02	-38.27	1.84*	1.94*
Earnings per share	-8.38	-14.5	0.66	0.83
Return on equity	-24.28	-31.87	0.6	1.17
Return on asset	-20.37	-25.22	0.63	1.07
PBITD/Capital employed	-13.34	-20.55	0.98	1.79*
PBITD/Total debt	-17.82	-28.72	1.1	1.51
<i>Risk and size in the pre-decline year</i>				
Risk (beta)	0.94	0.95	0.35	0.21
Size (£M)	355.6	100.1	2.85***	3.15***

**Table 8.1 Financial characteristics of recovery and non-recovery firms
[Poor performing sample] (Contd.)
Panel B: Post-decline performance**

	Recovery	Non- recovery	t-stat	z-stat
	Mean	Mean		
<i>Stock performance</i>				
Two year cumulative stock returns post-decline	58.78	-56.66	10.15***	8.45***
<i>Profitability and cash flows - average of two years post decline</i>				
PBIT/Sales	8.65	5.49	1.14	3.86***
Earnings per share	23.47	-17.01	6.35***	6.24***
Return on equity	18.34	6.08	2.63***	4.29***
Return on asset	17.54	7.99	4.56***	4.91***
PBITD/Capital employed	25.03	15.37	4.16***	4.09***
PBITD/Total debt	112.83	58.08	4.27***	5.57***

However, only two out of six operating performance indicators i.e. PBIT/Sales and PBITD/Capital employed, are weakly (significant at 10% only) different between the two groups. There is no difference in risk (beta) between the two groups. Non-recovery firms, however, are significantly smaller in size, as measured by pre-decline year market capitalisation, than recovery firms. Therefore, there is only weak evidence of differences in operating performance between non-recovery and recovery firms. But what about performance in the post-decline years? Do recovery firms actually achieve real gains in operating performance vis-a-vis non-recovery firms?

Panel B of Table 8.1 shows the cumulative stock returns of the two groups two year post-decline. Unsurprisingly, non-recovery firms register negative returns of nearly 57% whilst recovery firms rebound strongly by around 59% in two years' cumulative returns. Is the reversion in stock performance a market freak or are they related to underlying recovery in operating performance? Second part of Panel B shows the average of two post-decline years' profitability and cash flows of the two non-recovery and recovery groups. In all six measures, recovery firms outperform non-recovery ones by a significant margin (all statistically significant at 1%). Therefore, recovery in post-decline stock returns ranking in the market is no market freak but due to real gains in sample firms' operating performance.

Next, we explore the difference in ways in which managers of recovery and non-recovery firms go about restructuring their stricken firms. We look at the choice of strategies, their timing and intensity of implementation and their effectiveness as viewed by the stock market. Finally, we test for the impact of intensity of restructuring strategies on post-decline recovery in firm performance.

8.3 Frequency and timing of restructuring

Table 8.2 shows the frequency and timing of restructuring strategies pursued by recovery and non-recovery firms for three years, beginning with the year of decline. In the year of decline, operational restructuring is undertaken by over 60% of firms in both groups.

Table 8.2: Frequency and timing of restructuring strategies by recovery and non-recovery firms: Poor performance sample

This table shows the frequency of firms adopting specific restructuring strategies in response to performance decline. For detailed definitions of strategies see Table 6.1. The sample size for recovery and non-recovery firms are 77 and 111 respectively. Difference in proportions between recovery and non-recovery firms is tested using the non-parametric Mann-Whitney Wilcoxon test and significance of the z statistic at 1%, 5% and 10% is denoted by the symbols ***, **, * respectively. Sources: Press releases to the London Stock Exchange, Extel Financial News Summary, Hambro Corporate Register and Company Guide, Datastream International, and Company Reports and Accounts.

Restructuring strategy	Decline year			Decline year +1			Decline year +2		
	Proportions		z-stat	Proportions		z-stat	Proportions		z-stat
	Recovery	Non recovery		Recovery	Non recovery		Recovery	Non recovery	
Operational restructuring	63.60	63.10	0.08	51.90	66.70	2.02 **	37.70	61.30	3.17 ***
Asset sales	26.00	29.70	0.56	35.10	39.60	0.63	29.90	39.60	1.37
Acquisition	54.50	50.50	0.55	41.60	28.80	1.81 *	40.30	18.00	3.36 ***
Capital expenditure	75.30	63.90	1.65 *	59.70	51.40	1.14	61.00	38.70	3.00 ***
Managerial restructuring	14.30	18.00	0.68	22.10	27.90	0.90	9.10	30.60	3.51 ***
Dividend cut/omission	20.80	30.60	1.50	11.70	45.90	4.94 ***	5.20	54.10	6.93 ***
Equity issue	9.10	27.90	3.15 ***	14.30	10.80	0.71	14.30	12.60	0.33
Debt restructuring	2.60	2.70	0.04	1.30	6.30	1.67 *	1.30	11.70	2.67 ***
Cash generative actions	32.50	48.70	2.21 **	44.20	45.90	0.24	40.20	45.90	0.77

Heavy asset investment by acquisition characterised both groups in the year of decline, indicating over-investment as a potential cause of their decline. Between 20 and 30% of sample firms appear to start selling their assets and cut/omit dividends in the decline year. Significant differences between recovery and non-recovery firms in terms of decline year strategies lie in capital expenditure and cash generative actions such as equity issues. More recovery firms spend on capital expenditure than non-recovery ones (75% versus 64%). 28% of non-recovery firms tap the equity market whilst only 9% of recovery firms do so.

In the first post-decline year, restructuring intensifies, especially by non-recovery firms. Acquisitions though subside rapidly due presumably to liquidity constraints in both groups. Operational restructuring, dividend cut/omissions and debt restructuring are carried out by a significantly higher percentage of non-recovery than recovery firms. This trend is repeated in year two after decline where top management changes are also significantly more prevalent in non-recovery firms. Also, debt restructuring increases over time for non-recovery firms. The results clearly refute any suggestion that managers of non-recovery firms are inactive or sit on their backs in the wake of performance decline.

The efficacy of internal corporate control mechanisms is evident in the significant levels of managerial restructuring in firms that fail to recover two years post-decline. In contrast, for firms that recover within two years, asset investment features highly as a recovery strategy, significantly outweighing their non-recovery counterparts. This is consistent with the extant literature which suggests

investments as instrumental to the 'recovery stage' in corporate turnaround (e.g. Robbins and Pearce II, 1992; see Section 3.4.2). Managerial inaction is not an apparent cause of non-recovery as non-recovery managers restructure more intensively than recovery ones. Also, there is little timing difference between recovery and non-recovery firms. Non-recovery firms do not appear to lag behind their recovery counterparts in adopting restructuring strategies except for investments which they ill-afford. Therefore suggestions that non-recovery firms do not respond swiftly to decline are unsubstantiated. However, the lack of effectiveness of earlier strategy implementation may potentially be the reason for non-recovery firms taking significantly more restructuring actions than recovery ones.

8.4 Intensity of restructuring

In the previous section, we find little difference in the choice and speed of response to performance decline between recovery and non-recovery firms. If choice and speed of strategy execution are not a distinguishing factor between the two groups, could it be the lack of intensity in restructuring actions?

As discussed in Section 6.4.2, intensity of restructuring is measured using accounting and cash flow data relative to their pre-decline deflator or value and is summarised in Table 6.3.

Operational restructuring is measured by the ratio of cost of restructuring as reported in the company accounts to pre-decline year total assets. Asset sales,

acquisitions and capital expenditure are measured by the cash flows received/expended deflated by pre-decline year total assets. Management changes are represented by the number of changes (all) in executive and non-executive directors as a proportion of pre-decline year total number of directors. Dividend change (all) is the percentage change in current year dividends per share from the pre-decline year's. Equity issue is measured by cash raised by equity issue as a proportion of pre-decline year total assets. Debt restructuring is not examined due to the difficulty in quantifying the value of the restructuring package.

Table 8.3 shows the intensity of restructuring by recovery and non-recovery firms in response to performance decline. In the decline year, non-recovery firms appear to be more acquisitive than their recovery counterparts. However, non-recovery firms also restructure more intensively than recovery ones as they remove more top management, raise more equity funds and cash generation, in general.

Non-recovery firms also appear to restructure their operations more intensively than recovery ones one and two years post-decline. In the year after decline, non-recovery firms restructure their operations and top management more intensively than recovery ones. They also spend less on capital expenditure and dividends, presumably due to their tighter cash position than recovery firms.

Non-recovery firms are evidently required to continue restructuring two years post-decline due to lack of effectiveness in strategy implementation the previous year.

Table 8.3: Intensity of restructuring by recovery and non-recovery firms:**Poor performance sample**

This table shows the intensity of restructuring by recovery and non-recovery firms. Operational restructuring is measured by the cost of restructuring, including costs of layoffs and closures, as reported by the firm, to pre-decline year total assets. Asset sales, acquisitions and capital expenditure are those reported by the firm and measured by cash flows generated or expended / pre-decline year total assets. Managerial restructuring is all reported change in executive and non-executive directors from pre-decline year total number of directors (percentage). Dividend change is percentage change in reported current year dividends over the pre-decline year's. Equity issue is reported cash raised by equity issue/ pre-decline year total assets. Cash generative action is the sum of reported asset sales and equity issues. The sample size for recovery and non-recovery firms are 77 and 111 respectively. Difference in means between recovery and non-recovery firms is tested using t and non-parametric Mann-Whitney Wilcoxon tests, and their significance at 1%, 5% and 10% are denoted by the symbols ***,**,* respectively. Sources: Company press releases, Extel Financial and company reports and accounts.

Restructuring strategy	Recovery firms	Non-recovery firms	t-stat	z-stat
	Mean	Mean		
	<u>Decline year</u>			
Operational restructuring	2.22	3.01	0.77	0.68
Asset sales	4.58	7.85	1.31	1.14
Acquisition	16.3	36.64	1.79*	0.25
Capital expenditure	24.27	18.94	1.24	1.09
Managerial restructuring	4.93	10.01	2.84***	2.32**
Dividend change	45.26	40.54	0.37	0.06
Equity issue	5.31	17.68	2.27**	3.19***
Cash generative actions	9.89	25.53	2.65***	3.02***
	<u>Decline year+1</u>			
Operational restructuring	2.32	4.38	1.25	1.94*
Asset sales	9.27	13.99	0.8	1.26
Acquisition	9.01	19.99	1.24	1.59
Capital expenditure	23.64	17.66	1.4	1.81*
Managerial restructuring	6.82	14.08	3.48***	2.58***
Dividend change	57.3	14.82	2.35**	3.48***
Equity issue	8.28	6.83	0.36	0.69
Cash generative actions	17.55	20.82	0.45	0.81

Table 8.3: Intensity of restructuring by recovery and non-recovery firms in response to performance decline(Contd.)

	Recovery	Non recovery		
	Mean	Mean	t-stat	z-stat
	<u>Decline year + 2</u>			
Operational restructuring	1.11	5.04	3.17***	3.20***
Asset sales	6.33	12.62	1.45	1.66*
Acquisitions	18.71	8.98	1.18	3.05***
Capital expenditure	26.36	31.41	0.36	3.89***
Managerial restructuring	2.89	16.75	7.04***	5.86*
Dividend change	73.5	-17.33	4.32***	6.01***
Equity issue	11.76	5.12	1.02	0.31
Cash generative actions	18.09	17.74	0.04	1.15
	<u>Decline years+1 and + 2</u>			
Operational restructuring	3.43	9.41	2.85***	3.21***
Asset sales	15.61	26.61	1.41	2.14**
Acquisition	27.72	28.97	0.09	2.25**
Capital expenditure	49.31	46.75	0.18	3.16***
Managerial restructuring	9.7	30.84	7.11***	6.03***
Dividend change	125.8	-2.48	3.47***	4.92***
Equity issue	20.04	11.96	0.81	0.12
Cash generative actions	35.64	38.56	0.25	1.76*

In the second year, there are significant differences in all strategies except for cash generative equity issues. Additionally, non-recovery firms sell more assets and spend less on acquisitions than their recovery counterparts. Non-recovery managers appear to be following generic corporate turnaround strategies - restructure operations to cut costs, sell assets to raise cash or remove loss-making operations, and conserved cash via avoiding internal capital expenditure and/or acquisitions. Non-recovery firms' higher level of turnover in top management in

the third year of decline appears to be a result of further decline rather than a planned or premeditated strategy (the mean difference in top management changes in the last two years is also significant at 1%). However, the efficacy of internal control mechanisms is clear and managers are not spared the chop when corporate recovery is not imminent even two years after decline.

Mean dividend change is negative for non-recovery firms and positive for recovery ones two years post-decline. Unquestionably, dividend cut/omission is used intensively by non-recovery firms to conserve scarce cash resources. However, dividend cuts are clearly delayed until the second year after decline. In the first year, non-recovery firms are still increasing their dividend payout albeit at a lower rate than recovery firms. Perhaps, if non-recovery firms had cut their dividends earlier and conserve vital cash resources, they might have had a better chance of recovery. There appears to be no significant difference in respect of equity issue between the two groups.

Overall, over the two post-decline years, non-recovery firms do restructure more intensively than recovery firms. So, if non-recovery is not due to inaction, late action (except for dividend cut) or lack of intensity in actions, is poor strategy implementation the cause of non-recovery? It is plausible that managers of recovery firms are better at implementation than their non-recovery counterparts. We have to look at the shareholder wealth effects of strategy announcements for evidence of difference in implementation success. As discussed in Section 5.3, the wealth impact of strategy announcement captures the stock market's total

assessment of the strategy, its timing, intensity and expected implementation success. As effectiveness of strategy implementation is incapable of direct measurement, it can be deduced indirectly from stock market reaction⁴⁷. As we find earlier no evidence of difference in timing or intensity of strategies which could otherwise affect effectiveness, any difference in shareholder wealth impact between recovery and non-recovery firms can be deduced to stem from differences in strategy implementation.

8.5 Shareholder wealth impact of restructuring strategies

Taking a stock market perspective, Table 8.4 shows the frequency of news announcement made to the London Stock Exchange by the poor performance sample firms in the two post-decline years. Only post-decline announcements are examined due to need to avoid potential causality problems associated with announcements in the year of decline (see Section 6.1). Announcements in the decline year can be both the cause and effect of stock performance decline. We examine all stories reported for these years for all sample recovery and non-recovery firms. However, the number of stories examined is smaller than the actual announcements, as overlapping announcements are excluded to avoid contamination of wealth effects. Overlapping announcements are those reported within a two-week period (event window) of another announcement. The announcements relate to specific strategies under three generic strategies. Asset

⁴⁷We assume that the market has similar expectations across both groups. Hence, error in market anticipation, if any, is equal across both groups, and the unanticipated element of the news announcement relates exclusively to the effectiveness of the announced strategy.

restructuring comprises asset sales (divestment) and investment. Asset sales in turn are made up of sell-offs and management buyouts of subsidiaries, and other asset sales. Managerial restructuring covers replacement of Chairman or Chief Executive Officer⁴⁸. Financial restructuring comprises rights issue, dividend cut/omission and debt restructuring. As discussed in Section 5.4, examination of the shareholder wealth impact of operational restructuring is not possible due to the rarity in the UK of firms announcing operational restructuring as a separate event. Also, as explained in Section 5.4.3.2, internal capital expenditure is seldom announced as a separate event in the UK. Therefore, examination of the shareholder wealth impact of internal capital expenditure is not possible.

Non-recovery firms report more stories than recovery firms except for asset investment and equity rights issue. Potentially these stories are biased towards large firms, as small firms' less complex structure results in lower frequency of actions. However, when we run regressions of frequencies of stories about asset sales, acquisition, management changes, rights issue, dividend cut/omission, and debt restructuring on firm size, only asset sales are significantly (positively - adjusted $R^2 = 0.08$) associated with firm size. Since the size-effect is very small in the case of asset sales, we can take the view that the potential problem of a size bias is minimal.

⁴⁸Managerial restructuring is a term used throughout this thesis to refer to changes in top management ie. Chairman and CEO. The exception is when examining intensity of strategies, where it is more meaningful to investigate the percentage change in the board of directors than merely the Chairman and CEO. As changes in Chairmen and CEOs tend to be announced simultaneously, it is therefore not practicable to examine them individually.

Table 8.4: Frequency of announcements to the London Stock Exchange by recovery and non-recovery firms in two post-decline years: Poor performance sample

The table shows the number of announcements made to the London Stock exchange on strategic actions, in two post-decline years by poor performance firms. The number of announcement or stories examined is smaller than the actual announcements, as overlapping announcements are excluded to avoid contamination of wealth effects. Overlapping announcements are those reported within a two-week period (event window) of another announcement. Source: Company press releases and Financial Times Extel.

Announcement details	Type of news story	Recovery	Non recovery
Asset sales			
Number of firms		37	58
Number of stories		107	131
Average per firm		2.8	2.6
(median,minimum,maximum)		(1,1,21)	(1,1,15)
Sell-offs			
Number of firms		31	43
Number of stories		84	90
Average per firm		2.7	2.1
(median,minimum,maximum)		(1,1,15)	(1,1,13)
Management Buy-out			
Number of firms		12	19
Number of stories		21	28
Average per firm		1.8	1.5
(median,minimum,maximum)		(1,1,6)	(1,1,3)
Other asset sales			
Number of firms		2	9
Number of stories		2	13
Average per firm		1	1.4
(median,minimum,maximum)		(-,1,1)	(1,1,3)
Asset investment			
Number of firms		44	42
Number of stories		108	75
Average per firm		2.5	1.8
(median,minimum,maximum)		(1,1,9)	(1,1,8)
Managerial restructuring			
Number of firms		21	30
Number of stories		30	54
Average per firm		1.4	1.3
(median,minimum,maximum)		(1,1,3)	(1,1,3)

Table 8.4 Contd.

Announcement details	Type of news story	Recovery	Non recovery
Replace Chairman			
Number of firms		9	17
Number of stories		10	19
Average per firm		1.1	1.1
(median,minimum,maximum)		(1,1,2)	(1,1,2)
Replace CEO			
Number of firms		14	33
Number of stories		20	35
Average per firm		1.4	1.1
(median,minimum,maximum)		(1,1,3)	(1,1,2)
Equity/rights issue			
Number of firms		14	11
Number of stories		16	11
Average per firm		1.1	1
(median,minimum,maximum)		(1,1,2)	(-,1,1)
Dividend cut/omission			
Number of firms		18	66
Number of stories		31	117
Average per firm		1.7	1.8
(median,minimum,maximum)		(1.5,1,3)	(2,1,4)
Dividend cut			
Number of firms		16	49
Number of stories		27	70
Average per firm		1.7	1.4
(median,minimum,maximum)		(1.5,1,3)	(1,1,3)
Dividend omission			
Number of firms		3	34
Number of stories		4	47
Average per firm		1.3	1.4
(median,minimum,maximum)		(1,1,2)	(1,1,3)
Debt restructuring			
Number of firms		1	9
Number of stories		1	10
Average per firm		1	1.11
(median,minimum,maximum)		(-,1,1)	(1,1,2)

Table 8.5 shows the stock market's response to strategy announcements by both recovery and non-recovery firms. Panels A and B show the market and size adjusted cumulative abnormal returns surrounding announcement of restructuring in the two post-decline years. Significance of abnormal returns is tested for using the dependence test described in Appendix 6.1.

To increase focus, risk and mean adjusted returns are shown as Appendix 8.1. Risk adjusted returns are used in the discussion for comparison purposes only. The reason is risk adjusted or market model returns potentially suffer from contamination caused by overlapping beta estimation periods (-170 days to -20 days of announcement date) where there exist multiple announcements during the 150 day estimation periods. Also, as results from the mean adjusted model are similar to those from other models, and for reason of avoiding the potential upward bias in mean-adjusted returns, due to the negative returns in the estimation period, they are not discussed. The following discussion is based on the market-adjusted model whilst the size-adjusted model is used for checking the robustness of the market-adjusted results. Also, to increase focus, we present only results for the main category of strategies. For example, we show only asset sales but not the three specific types of asset sales ie. sell-offs, MBOs and other asset sales, in the main text. However, where the results from the specific strategies are interesting, there are footnoted.

Table 8.5: Cumulative abnormal returns surrounding announcement of restructuring in the two post-decline years: Poor performance sample

This table shows the cumulative abnormal returns (CAR) based on the market- and size-adjusted models. Returns are cumulated from Day -5 to Day +5 centred on strategy announcement day, Day 0. N denotes number of cases (reported earlier in Table 8.4). Significance of abnormal returns is tested for using the dependence test described in Appendix 6.1. Differences in mean abnormal returns between recovery and non-recovery firms are tested for using t and non-parametric Mann-Whitney Wilcoxon tests. ***, **, * indicate significance at 1%, 5% and 10% levels respectively

Restructuring strategies	Recovery			Non-recovery			Diff. in		
	N	CAR %	t value	N	CAR %	t value	mean	t-stat	z-stat.
Panel A: Market-adjusted model									
Asset sales	107	0.68	0.81	131	-1.87	-1.44	2.54	0.04	0.09
Acquisition	108	1.88	3.34 ***	75	-1.92	-1.69 *	3.80	0.01	0.02
Managerial restructuring	30	1.86	1.18	54	-5.84	-3.51 ***	7.70	0.00	0.01
Rights issue	16	-3.95	-2.72 **	11	-4.26	-1.44	0.30	0.96	0.76
Dividend cut/omission	31	-0.36	-0.17	117	-8.09	-6.26 ***	7.73	0.09	0.00
Debt restructuring	1	8.13	0.80	10	-4.76	-0.64	12.89	-	0.52
Panel B: Size-adjusted model									
Asset sales	107	1.06	1.27	131	-0.82	-0.64	1.88	0.11	0.29
Acquisition	108	2.54	4.55 ***	75	-0.69	-0.63	3.23	0.00	0.00
Managerial restructuring	30	3.65	2.43 **	54	-3.85	-2.38 **	7.50	0.00	0.01
Rights issue	16	-2.88	-2.10 *	11	-2.92	-1.03	0.04	0.99	0.76
Dividend cut/omission	31	-0.29	-0.14	117	-6.82	-5.38 ***	6.53	0.15	0.00
Debt restructuring	1	6.36	0.62	10	-4.61	-0.61	10.97	-	0.52

In Panel A, market reactions to asset sales strategies for both groups are insignificant with CAR of 0.68% for recovery firms and CAR of -1.87% for non-recovery firms. Significantly, recovery firms outperform their non-recovery counterparts by a margin of 2.54% on asset sales⁴⁹.

In Appendix 8.1, the market model results of CAR around 1.5% for asset sales announcements are lower than prior studies which report market model CAR from 3.55% (Hearth and Zaima, 1984) to 5.07% (Lang et al, 1995). CARs from prior studies employing smaller event windows range from 0.85% (day 0, Afshar et. al., 1992) to 1.27% (day -2 to 0, Lasfer et. al., 1996) to 2.14% (day -1 to 0, Brown et al, 1994).

Recovery firms also appear to trump the non-recovery firms in terms of asset investment strategies. They record a significantly positive CAR of 1.88% on announcements of acquisitions. This is in contrast to a significantly negative CAR of 1.92% for non-recovery firms. On average, recovery firms outperform non-recovery ones by a significant 3.80% when acquisitions are announced. The market model result for the recovery sub-sample, CAR of 2.07%, is significant and slightly higher than the 1.72% reported by Khanna and Poulsen (1995) for their control sample of healthy firms announcing acquisitions or expansions. Khanna and Poulsen find only a small but insignificant positive CAR for Chapter 11 firms.

⁴⁹The cause of the difference lies in the significant negative CAR of 6.01% for MBOs carried out by non-recovery firms. In fact, the difference in CARs between the two groups' MBO announcements is a significantly high 8.18%.

This is comparable to our market model results of a small but insignificant negative CAR of 0.11% on announcement of acquisitions by non-recovery firms.

The effectiveness of managerial restructuring strategy is evidently captured by stock market reaction for non-recovery firms but not for recovery firms. Recovery firms increase their shareholder wealth by an insignificant 1.86% as compared to a significant decrease of 5.84% for non-recovery firms. The mean difference of 7.7% between the two groups is significant at less than 1%⁵⁰. Our market model results are a significant positive CAR of 2.99% and an insignificant CAR of 0.9% for recovery and non-recovery firms respectively. Conversely, Khanna and Poulsen find a significant (insignificant) CAR of -2.09% (-1.67%) on announcement of top management changes in Chapter 11 (control) firms in their study. However, in both studies the recovery and healthy firms out perform the non-recovery and Chapter 11 firms respectively.

In the case of financial restructuring strategies, both recovery and non-recovery groups register CARs of -3.95% and -4.26% respectively on announcement of rights issues. However, it is statistically significant only for the recovery group. The significant negative reaction is consistent with reaction to equity issues by all firms. As a comparison to the literature on seasoned equity offerings, the market model results, CAR of -4.4% and -3.9% for recovery and non-recovery firms, are comparable to prior studies of market model CARs of

⁵⁰Significantly, non-recovery firms underperform recovery ones by a staggering 9.2% when their CEOs are replaced.

-3.5% (Schipper and Smith, 1986) to -4.68% (Mikkelsen and Partch, 1986) for day-4 to day 0, the announcement day.

In the case of dividend cut or omission announcements, non-recovery firms experience significantly negative CAR of 8.09% compared to an insignificant negative CAR of 0.36% for recovery firms⁵¹.

Barring a few exceptions, the results from the size-adjusted model in Panel B are quite similar to the market-adjusted model. Management changes in recovery firms generate a significantly positive CAR of 3.65%⁵². However, the mean differences in CARs for asset sales are no longer significant, on a size-adjusted basis.

The results provide strong evidence on the effectiveness of asset and managerial restructuring strategies but less so for equity-based strategies. Although dividend cut/omission is greeted indifferently (CAR of -0.36%) by recovery firm shareholders, non-recovery firm shareholders respond significantly negatively

⁵¹Interestingly, dividend cut is viewed more gravely by the market than dividend omission. The market appears to be of the opinion that an omission is more appropriate than paying reduced dividends in view of the firms' bad financial shape. These results must be interpreted with caution as dividend cut and omission news in the main are contaminated by other information contained in company results released at the same time. However, the results contradict that of Marsh (1992). Marsh's study of dividend cuts (omissions) by UK firms between January 1989 and April 1992 shows dividend cuts (omissions) to generate -4.3% (-7.4%) size-adjusted returns. This compares with our non-recovery firms size-adjusted returns of -7.33% and -6.07% for dividend cut and omission respectively. The mixed results could be due to Marsh's inclusion of non-performance decline induced cuts and, as qualified earlier, contamination caused by other information revealed during dividend announcements. The latter problem is also recognised by Marsh in his study.

⁵²CEO replacements contributing the bulk of the significant gains with mean CAR of 4.20%. Also, the previously significant negative CAR for MBOs in non-recovery firms is now no longer significant.

(CAR of -7.42%) to their firm's dividend cut/omissions. However, the effectiveness of these actions may be confounded by the negative signals they convey to the market of the firms' future cash and earnings potential (dividend is normally announced at the same time as company results). Rights issue is also greeted by the market with the same contempt as dividend cut/omissions, although it is only significant for the recovery firms. Therefore, for firms aiming to recover swiftly to previous levels of market performance, equity-based strategies are to be discouraged, unless absolutely necessary.

Summary of shareholder wealth impact of restructuring strategies

Table 8.6 summarises the results in Table 8.5, and shows only results with significant CARs or where the difference between the recovery and non-recovery groups' CARs is significant, across the two models- market- and size-adjusted models. Appendix 8.2 shows the same for the risk- and mean-adjusted models.

In terms of asset restructuring, non-recovery managers are considered less effective (market-adjusted CAR is 2.54% lower than for recovery firms) in their implementation, specifically MBOs and acquisitions⁵³.

⁵³However, in terms of sell-offs, non-recovery firms appear to perform better than recovery ones in terms of risk-adjusted and mean-adjusted returns. In both these models, non-recovery firms register significant positive CARs on announcement compared to insignificant positive CARs by their recovery counterparts.

Table 8.6: Summary of shareholder wealth impact of strategy announcements

This table summarises Table 8.5 and shows only results with significant CARs or where the difference between the recovery and non-recovery groups'

CARs are significant, across the two models - market- and size-adjusted models.

Restructuring strategies	Market-adjusted returns			Size-adjusted returns		
	Recovery CARs	Non-recovery CARs	Diff.	Recovery CARs	Non-recovery CARs	Diff.
Asset sales	0.68	-1.87	2.54**			
Acquisitions	1.88***	-1.92*	3.80**	2.54***	-0.69	3.23***
Managerial restructuring	1.86	-5.84***	7.70***	3.65**	-3.85**	7.50***
Rights issue	-3.95**	-4.26	0.30	-2.88*	-2.92	0.04
Dividend cut/omissions	-0.36	-8.09***	7.73***	-0.29	-6.82	6.53***

Managerial restructuring when undertaken by non-recovery firms is considered inadequate or inappropriate⁵⁴.

In the case of rights issue, the recovery firms suffer significantly negative CARs on announcement compared to insignificantly negative CARs for the non-recovery firms, across all four models.

As regards dividend cut/omissions, three out of four models show non-recovery firms to suffer a negative CAR on announcements. In comparison, recovery firms are equally split - with two models reporting positive CARs and two models reporting negative CARs - all of which are insignificant.

In summary, the empirical evidence shows turnarounds to be affected by effectiveness of implementation of restructuring strategies. Consequently, the results emphasise that incompetent managers contribute to continuing corporate decline and are the possible villains of corporate failures. Despite following the same restructuring strategies, and in greater intensity, than their recovery counterparts, they are perceived by the market to implement them less effectively. The only exception is equity issues. In this case, the adoption of equity issues by recovery firms is viewed with greater contempt by the market than that by non-recovery ones.

⁵⁴This is evidenced by significantly lower CARs on announcements of CEO replacement (in fact, negative) by non-recovery firms than recovery firms across all four models.

8.6 Restructuring and corporate turnaround

As discussed in Section 6.2.5, corporate turnaround or recovery is defined as return to top 50% in two years cumulative stock returns ranking in the market.

From the previous section, we find most restructuring strategies are effective in terms of increasing shareholder wealth (except for strategies such as dividend cut/omission and rights issues), provided they are perceived by the stock market to be implemented successfully. As discussed in Section 5.2, an alternative and indirect method for examining strategy effectiveness is to test the association between restructuring strategy and the extent of corporate recovery from performance decline. This involves running a logit regression and an OLS regression of recovery, on two year post-decline intensity of restructuring strategies and control variables. The objective is to test for the impact of post-decline restructuring intensity on recovery. As the outcome of restructuring is recovery or non-recovery, logit regression measures the impact of explanatory variables on the likelihood of a firm recovering or not recovering. Recovery is restoration of the firm to top 50% ranking in two post-decline years' cumulative stock returns. OLS regression complements logit regression by capturing the degree of recovery as represented by two years' cumulative stock returns ranking in the market.

Results of logit and OLS regressions

Table 8.7 shows the results of logit and OLS regressions of recovery on

intensity of restructuring strategies and control variables. The signs of coefficients in both logit and OLS regressions are similar. The R^2 of both regressions is extremely high, proving that restructuring strategies and the contextual variables explain substantially both recovery and firm's stock returns ranking in the market. Operational restructuring appears to have a significant and negative impact on corporate recovery. As in a prior study by Blackwell et al.(1990) operational strategies are greeted negatively by the market. In addition, as discussed earlier in Section 8.3, non-recovery firms appear to resort significantly more frequently to operational restructuring than their recovery counterparts. Repeated attempts at a strategy are interpreted by the market as failure on the part of managers to tackle effectively the cause of decline in earlier implementation.

Similarly, higher intensity of managerial restructuring is negatively related to recovery and stock returns ranking. Again, the market dislikes repeated replacements of top managers and views them with scepticism.

Asset restructuring strategies - asset sales and acquisitions appear to be very much the common strategy adopted by both groups, resulting in a lack of significance in explaining recovery. Dividend change is positively related to recovery. In other words, dividend cuts or omissions are detrimental to stock returns recovery, corroborating earlier event study results. As discussed in section 5.6.1, managers cut/omit dividends only as a last resort, when their efforts at turning around the firm are not succeeding. Therefore, dividend cuts/omissions can both precede and induce stock returns decline, and hence recovery.

Table 8.7: Logit and OLS regressions of recovery and post-decline two year cumulative stock returns ranking, on intensity of restructuring strategies and control variables

Coefficients of the logistic and OLS regressions of recovery and post-decline two year cumulative stock returns ranking in the market, on two year post-decline intensity of restructuring strategies and control variables are shown. See Tables 6.2 and 6.3 for definitions. Coefficients are tested for significance using the Wald / t-test statistic. p values for either test statistic are shown to indicate significance. Source: Datastream International, Company Reports and Accounts, Extel Financial, Hambro Company Guide and Hambro Corporate Register.

Model: Recovery/Stock returns ranking = f(Operational, asset, managerial and financial restructuring intensity, and control variables)

	Model 1		Model 2	
	Logit regression		OLS regression	
	Coefficients	p	Coefficients	p
Operational restructuring	-3.60	0.08	-16.31	0.09
Asset sales	-0.08	0.84	-2.30	0.40
Acquisitions	0.08	0.74	0.88	0.60
Managerial restructuring	-0.05	0.00	-0.26	0.00
Dividend changes	0.17	0.07	1.99	0.00
Equity issue	0.48	0.28	5.28	0.04
Debt restructuring	-2.30	0.04	-14.77	0.00
Internal cause of decline	-0.09	0.87	-1.76	0.60
Severity of decline	0.02	0.53	0.29	0.28
Firm size	0.46	0.02	2.38	0.05
Economic condition	-0.02	0.73	-0.17	0.70
Industry condition	0.02	0.00	0.17	0.00
Constants	-1.35	0.14	42.45	0.00
McFadden's R-Square /Adj R ²	46.9%		55.8%	
Chi-square / F statistic	119.20		19.20	
Regression p-value	0.00		0.00	

The only inconsistency between the regression results and event study results lies in equity issue. Earlier, in Section 8.4, we found equity issue announcements, on average, to be accompanied by a significant decrease in stock returns. However, in the OLS regressions, the results show higher intensity of equity issue to be associated with a higher level of post-decline stock returns ranking in the stock market. The results suggest that in spite of stock market's dislike for equity issues, a successful equity issue brings in much needed cash to turnaround the declining firm. Similar to earlier event study results in section 8.4, debt restructuring is negatively associated with recovery and stock returns ranking.

Firm size and industry conditions appear to exert a significant impact on the likelihood of recovery or stock returns ranking in the market. Large firms and firms facing good industry condition during the restructuring period are more likely to recover from performance decline. Economic condition, however, has no significant impact on recovery and stock returns ranking. Therefore, factors largely beyond management control such industry condition and firm size do influence firms' recovery prospects.

Overall, the logit and OLS regression results confirm the results in Section 8.3 on the intensity of restructuring strategies by the two groups of recovery and non-recovery firms. In that section, we find non-recovery firms to restructure more intensively than their recovery counterparts. Hence, we find higher levels of operational and managerial restructuring, dividend cut/omission, and debt restructuring to be associated with non-recovery and lower levels of post-decline

stock returns ranking in the market. Also, the regression results confirm the event study results in section 8.4. In that section, we find the stock market to be able to discern between good and bad strategy implementation and rate strategy announcements accordingly. The shareholder wealth impact of strategy announcements is more positive in recovery than in non-recovery firms e.g. asset sales and managerial restructuring.

Therefore, we can infer that the negative impact of high restructuring intensity (a hallmark of non-recovery firms) on recovery or stock returns ranking to stem from investors' lack of confidence in managers' ability to implement restructuring effectively.

Finally, it appears from the regression results that there may be a potential causality problem, in that the cause and effect of strategies may be indeterminable. In other words, a strategy may be caused by the decline or the strategy itself may have caused the decline. Take the example of the strong negative association between dividend change and corporate recovery. Although adopting a dividend cut is a good recovery measure aimed at conserving scarce cash resources, it can also be a reflection of the severity of the firm's financial decline. In other words, dividend cut can both be a recovery strategy and a cause of decline in stock returns and non-recovery. Therefore, conclusions cannot be drawn solely on the regression results but rather used in conjunction with the event-study, frequency, timing and intensity results.

8.7 Summary and conclusions

In Chapter 5, we reviewed the extant studies on corporate turnaround and found a myriad of factors contributing to corporate recovery and failure. Adopting a prescribed range of restructuring strategies with vigour and intensity was suggested, in past case study and small sample analyses, as central to recovery. Corporate downward spiral to failure was attributed to managerial inaction. We argue that manager's strategy implementation process rather than inaction is responsible for non-recovery. In other words, restructuring strategies are only as good as the people responsible for executing them.

In this chapter, we set out to test the factors underlying strategy effectiveness. We examine the frequency of prescribed strategies by 188 recovery and non-recovery firms. We investigate the timing, intensity and shareholder wealth impact of restructuring strategies. Shareholder wealth impact is measured by abnormal market-, size-, risk- and mean-adjusted returns around strategy announcements. The effectiveness of strategies in achieving turnaround is also examined by way of logit and OLS regressions of recovery, stock returns ranking in the market, on restructuring intensity and contextual factors.

The results show no support for managerial inaction as a contributor to non-recovery from poor performance. Instead of being paralysed by inertia, managers of non-recovery firms appear to take early and intensive restructuring actions. These firms even have a higher proportion of their top managers removed than their recovery counterparts. The evidence does not support timing as a cause of

non-recovery, as a higher proportion of non-recovery than recovery firms appear to restructure their operations in each of the two post-decline years. Specifically, more non-recovery firms restructure their operations, remove their top managers, cut/omit dividends and restructure their debts. Non-recovery firms also appear to restructure more intensively than recovery ones except for investment strategies which they could ill afford.

Our results suggest the root cause of non-recovery is in bad implementation of restructuring strategies. For similar strategies, non-recovery firms' managers are perceived by the market to be far less effective in their implementations. In particular, the core rescue strategies of asset sales and managerial restructuring, and growth-oriented acquisition strategies pursued by such firms are significantly less well received by the market. Somehow, managers of non-recovery firms seem to have less credibility than their recovery counterparts in terms of strategy implementation. Higher restructuring intensity by non-recovery firms appears to be necessitated by failure of earlier strategy implementation. Instead of high intensity leading to higher recovery potential, it results in disillusioned investors marking the firm's potential considerably lower than their recovery counterparts. This is supported by logit and OLS regression results which show higher levels of restructuring to be associated with lower probability of recovery and lower levels of stock returns ranking. Significantly, restructuring strategies, firm size and industry condition appear to explain a very substantial part of cross sectional two-year post-decline returns of poor performing firms.

In conclusion, faithful and intensive adoption of prescribed restructuring strategies is an insufficient condition for corporate recovery from poor performance. Investors appear to be able to discern between effective and ineffective implementation and respond appropriately by marking up or down the firm's recovery potential. Our results appear to suggest that some corporate managers are, perhaps, poor turnaround managers. Potentially, there may be a case for engaging professional turnaround managers with diverse experience in turning around ailing firms to enhance strategy implementation success and hence recovery. Further research is necessary to identify and explore in-depth the role of professional turnaround managers and other factors aiding or impeding effective implementation of turnaround strategies.

Appendix 8.1: Cumulative abnormal returns surrounding announcement of restructuring in the two years post-decline

	Recovery			Non-recovery			Diff. in		
	N	CAR%	t value	N	CAR%	t value	mean	t-stat	z-stat.
Panel A: Risk-adjusted or market model									
Asset sales	107	1.5	1.75 *	131	1.43	1.07	0.07	0.95	0.76
Acquisition	108	2.07	3.48 ***	75	-0.11	-0.1	2.18	0.06	0.18
Managerial restructuring	52	2.99	2.36 **	110	-0.9	-0.89	3.88	0.02	0.08
Rights issue	16	-4.43	-3.16 ***	11	-3.94	-1.37	-0.49	0.92	0.96
Dividend cut/omission	31	1.2	0.57	117	-4.32	-3.37 ***	5.52	0.25	0.01
Debt restructuring	1	4.74	0.48	10	2.08	0.27	2.66	-	0.52
Panel B: Mean-adjusted model									
Asset sales	107	1.7	1.79 *	131	1.49	1.15	0.21	0.87	0.71
Acquisition	108	2.59	3.98 ***	75	-0.34	-0.3	2.93	0.02	0.06
Managerial restructuring	52	3.08	2.4 **	110	-0.83	-0.8	3.91	0.02	0.1
Rights issue	16	-4.64	-3.16 ***	11	-4.16	-1.45	-0.48	0.93	1
Dividend cut/omission	31	2.62	1.24	117	-3.97	-3.03 ***	6.58	0.15	0.01
Debt restructuring	1	-1.76	-0.16	10	4.2	0.56	-5.96	-	1

Appendix 8.2: Summary of shareholder wealth impact of strategy announcements

This table summarises Appendix 8.1 and shows only results with significant CARs or where the difference between the recovery and non-recovery groups' CARs are significant, across all the two models - risk- and mean-adjusted models.

Restructuring strategies	Risk-adjusted returns			Mean-adjusted returns		
	Recovery CARs	Non-recovery CARs	Diff.	Recovery CARs	Non-recovery CARs	Diff.
Asset sales	1.50*	1.43	0.07	1.70*	1.49	0.21
Acquisitions	2.07***	-0.11	2.18*	2.59***	-0.34	2.93**
Managerial restructuring	2.99**	-0.90	3.88**	3.08**	-0.83	3.91**
Rights issue	-4.43***	-3.94	-0.49	-4.64***	-4.16	-0.48
Dividend cut/omissions	1.20	-4.32***	5.52**	2.62	-3.97***	6.58**

Chapter 9. DETERMINANTS AND EFFECTIVENESS OF RESTRUCTURING STRATEGIES BY DISTRESSED FIRMS: RESULTS OF EMPIRICAL ANALYSIS

9.1 Introduction

We explored the determinants and effectiveness of restructuring strategies by poorly performing firms in Chapter 7 and 8. In this chapter, we repeat the analysis for a sample of distressed firms. The rationale for examining a sample of distressed firms is presented in Section 2.6. Poor performance is but an early stage of a firm's performance decline. It may lead to distress and eventually liquidation (see performance decline research framework illustrated in Figure 2.1). A complete analysis of the determinants and effectiveness of restructuring strategies necessitates the examination of the different stages of performance decline. We therefore examine the two stages of decline - poor performance and distress⁵⁵. As discussed in section 2.6, we use negative Z scores to proxy for financial distress.

As discussed in Section 6.2.1, distressed firms are firms which experience a sharp decline in financial health i.e. to a negative Z score position after having been in a positive Z score position for at least two consecutive years. The sample consists of 201 firms declining into financial distress during the period 1983 to 1993. Sample's descriptive statistics are presented in Table 6.9. We employ similar methodology to that used for the poorly performing sample to test for the impact of agency and control variables on strategy choice and the effectiveness of strategies in contributing to turnaround. The exception is the effectiveness analysis

⁵⁵There may be some overlap between the two stages of decline, hence, the two samples may contain some overlapping firms.

based on event study analysis of strategy announcements used in the poorly performing sample. For the distressed sample, both distress and turnaround are measured in terms of accounting numbers from annual accounts. Hence, event study analysis is not feasible (see Chapter 6 for discussion).

9.2 Impact of stakeholder dominance on turnaround strategy choice

As with the poorly performing sample (see Section 7.2), we divide our distressed firm sample into two groups - one stakeholder dominated and the other non-dominated by that stakeholder. For each stakeholder group - lenders, manager-owners, block shareholders, CEO and collective board of directors - we examine the likelihood of a given strategy being chosen. The difference in the proportions of sample firms in the dominated and non-dominated groups choosing a strategy is tested for statistical significance. Any significant difference reflects the influence of the dominant stakeholder.

Table 9.1 shows the proportions of sample firms pursuing a given strategy in the distress and two post-distress years when the differences in these proportions between dominant and non-dominant groups are significant. Sample firms are lenders dominated when their leverage is in the top quartile of all the sample firms and they are in severe distress (bottom 50% in sample Z score ranking in the year of distress). Lenders under such circumstances are likely to have high stakes in recovery and to exercise their priority rights.

Table 9.1: Stakeholder dominance and choice of restructuring strategy (Contd)

	Year of distress		Year of distress+1		Year of distress+2	
	Yes	No	Yes	No	Yes	No
	Z	Z	Z	Z	Z	Z
Panel C: Blockholder dominance						
Asset sales	0.17	0.40	2.53**	0.37	0.45	0.83
Cash generative actions	0.26	0.49	2.55**	0.40	0.53	1.41
Number of observations	35.0	166.0	35.0	156.0	22.0	144.0
Panel D: Dual-CEO dominance						
Acquisitions	0.58	0.48	1.06	0.46	0.29	1.78*
Capital expenditure	0.71	0.51	2.09**	0.68	0.46	2.13**
Equity issues	0.29	0.15	1.85*	0.39	0.21	2.12**
Managerial restructuring	0.26	0.34	0.90	0.21	0.30	0.93
Sample size	31.0	170.0	28.0	163.0	25.0	141.0

Table 9.2: Impact of stakeholder dominance on restructuring strategy choice by distressed firms

The table shows the predicted and actual impact of individual stakeholder dominance on restructuring strategy choice. The predicted impact is discussed in Section 4.3 and presented in Table 4.2 while the actual impact is summarised from Table 9.1. The signs +, -, 0 denote 'favoured', 'resisted' and 'neutral' by the dominant stakeholder.

Generic strategies	Specific strategies	Lender		Manager-owner		Dual-CEO		Blockholders		Collective board	
		Pred.	Actual	Pred.	Actual	Pred.	Actual	Pred.	Actual	Pred.	Actual
Operational	Cost cutting, layoff, closures and integration of business	+	0	-	-	-	-	+	0	+	0
	Divestment	+	0	-	0	-	0	-	-	+	0
	Investment	-	-	+	0	+	+	-	0	+	0
Managerial	Replace top management	+	0	-	0	-	-	+	0	+	0
Financial	Equity:										
	Dividend cut/omission	+	+	-	-	-	0	-	0	+	0
	Equity issue	+	0	-	0	-	+	-	0	+	0
Combined	Debt: Restructure debt	-/+	+	-	0	-	0	-	0	+	0
	Cash generative	+	0	-	0	-	0	-	-	+	0

Sample firms are manager-owner dominated when they are not lenders dominated according to the above definition and the managerial and manager-associated shareholdings are in the top quartile of all sample firms.

Where neither lenders nor manager-owners are dominant according to the above definitions and the unassociated block shareholding is in the top quartile of all sample firms, the firms are deemed block shareholders dominated. Finally, the sample firms not dominated by lenders, manager-owners and block shareholders, are deemed to be under the control of the board of directors. In turn, the board may be dominated by a dual-CEO or collectively by the board members.

The results in Panel A to E of Table 9.1 is summarised in Table 9.2. Table 9.2 also presents, for comparison purpose, the predicted impact of individual stakeholder dominance as discussed in Section 4.3 and presented in Table 4.2.

9.2.1 Lender dominance

From Table 9.2, lenders dominated firms are more likely to opt for dividend cut/omission and debt restructuring. They are less likely to approve of cash-consuming strategy such as capital expenditure. Lenders' impact, where significant, mostly matches predictions made in Table 4.2. However, lenders do not have any impact on operational restructuring and managerial restructuring, divestments and equity issues. As with the poorly performing sample, the positive rather than negative relation with debt restructuring is by construct, since lender dominance only exists in highly geared firms, which incidentally, are more likely to require debt restructuring.

9.2.2 Manager and dual-CEO dominance

Manager-owner dominated firms are less inclined to pursue operational restructuring, and dividend cut/omission. Dual-CEO dominant board influence is extensive. Distressed firms dominated by their dual-CEOs prefer acquisitions, capital expenditure and equity issues. Dual-CEOs' preference for equity issues over all the three years is unexpected. They appear to be taking a high risk approach to alleviate distress. It appears that they are able to pacify shareholders' contempt for equity issues perhaps by tempting them with the chance of recovery through (risky) investments. Dominant dual-CEOs, predictably, reduce the probability of managerial restructuring. However, strangely, they also make management changes more likely, in the third year. Plausibly, dominant CEOs, through their expansionist policies, may have run down the firm to a state whereby their entrenched position no longer protects them from being sacked! In summary, the behaviour of dominant owner-managers and dual role CEO are close to predictions made earlier except for the lack of impact on divestment and debt restructuring. Perhaps, we have to look at the logistic regressions later in the chapter for pointers to their impact.

9.2.3 Blockholder dominance

When firms are dominated by blockholders, their influence is weak and limited to resisting cash generative asset sales. The actual impact is therefore much weaker than that predicted in Section 4.3. The lack of impact is perhaps

unsurprising. Since shareholders have low priority rights to capital repayment in the event of failure, their influence during distress, a stage close to failure, is understandably weak. So far the empirical evidence shows only lenders and managers to have significant influence over strategy choice when a firm is in financial crisis. Again, we have to look at the logistic regressions later for more evidence.

9.2.4 Board dominance

Collective board dominance influences is non-existent during financial distress. Again, we have to look at the logistic regressions later for more evidence.

Having explored the impact of stakeholder dominance on restructuring strategy choice, we shall examine the individual and joint impact of agency monitoring mechanisms on such choice.

9.3 Impact of individual agency monitoring mechanisms on restructuring strategy choice

In this section, we employ the following empirical model to test for the impact of agency monitoring on restructuring strategy choice in distressed firms.

$$CRS = f(\textit{Agency and control variables})$$

Definitions and descriptive statistics of dependent variables are contained in Tables 6.1 and 6.10 and those of explanatory variables in Tables 6.3 and 6.10.

Tables 9.3 to 9.5 report the model coefficients for the logistic regressions of corporate restructuring strategy choices on the agency and control variables. A

separate regression is run for each strategy and for each of the following years: year of distress (the distress year), the year after the distress year (distress year + 1) and the second year after the distress year (distress year + 2). These years coincide with the accounting years of the sample firms.

As with the poorly performing sample (see Section 7.3), we run all the regressions reported in Tables 9.3 to 9.5 using leverage and inside and outside shareholding, to avoid any multi-collinearity problem. Testing of the separate impact of lender and ownership types is reported later in this chapter.

9.3.1 Strategy choices and their determinants in the distress year

In the distress year, in Table 9.3, the logistic models are significant (based on the Chisquare statistic) except where managerial restructuring and equity issue are the dependent variables. Significance of the individual variables is tested for using the Wald statistic⁵⁶ The explanatory power of the models, measured by McFadden's R^2 , ranges from 4% to 18%

The impact of several agency and control variables is felt in the distress year. Lenders make debt restructuring more likely in the year of distress. As discussed earlier in Section 7.2, the relation can be positive by construct, since high leverage firms may have a higher probability of debt restructuring. Inside shareholders make operational restructuring less likely. Similarly, outside shareholders also disfavour operational restructuring. In addition, outside shareholders also disfavour asset sales, acquisitions, capital expenditure, equity issues and cash generative actions.

⁵⁶ To simplify the tables, the Wald statistic is not reported and only its level of significance indicated when it is significant at least at the 10% level.

Table 9.3: Logistic regression of restructuring strategies on agency and control variables: Distress year

Coefficients of the logistic regressions of restructuring strategies on agency and control variables are presented. The dependent variable equals one if a strategy is undertaken, and zero if otherwise. The explanatory variables are based on pre-distress year's, except for economic and industry condition, which are based on current year's, figures. The sample consists of 201 firms becoming distressed during the accounting periods ending in 1985 to 1993. The distress year refers to the year in which a firm's Z score declines to below zero, after two consecutive years of positive Z score rating. Refer to Tables 6.1 and 6.2 for definitions, and Table 6.11 for descriptive statistics. Coefficients are tested for significance using the Wald test statistic. ***, **, * indicate significance at 1%, 5% and 10% respectively.

Model: Restructuring strategy = f(Debt, ownership and governance variables, and control variables)

Explanatory variables	Operational restructuring		Asset sales	Acquisition	Capital expenditure	Managerial restructuring	Dividend cut/ omission	Equity issue	Debt restructuring	Cash generation
	0.68	0.36								
Leverage	1.39	0.36	-0.85	-0.14	-0.16	2.34	0.36	7.76*	0.38	
Inside shareholding	-0.01*	0.00	0.00	-0.01	0.00	0.00	0.00	-0.01	0.00	
Outside shareholding	-0.02*	-0.03***	-0.03***	-0.03***	0.01	0.01	-0.02*	0.04	-0.03***	
Chairman cum CEO	-0.23	0.21	0.61*	0.07	-0.37	-0.61	-0.11	-1.00	0.21	
Non executive Chairman	-0.56	-0.18	0.49	-0.78*	0.02	-0.70	-1.30	-1.52	-0.45	
Proportion of outside directors	0.92	0.15	-0.67	-0.40	-0.22	-0.43	0.79	-1.00	0.28	
Economic condition	-0.12	0.18**	0.12	0.22***	-0.02	-0.31***	0.13	-0.52**	0.17**	
Industry condition	0.02	0.01	0.06	0.03	-0.07	0.08	-0.05	-0.19	-0.02	
Internal problem	0.57	-0.35	0.01	0.37	-0.22	0.27	-0.54	2.18**	-0.50	
Severity of distress	0.00	0.00	0.12	0.10	-0.10	-0.32***	0.07	-0.39***	0.03	
Size	-0.21*	-0.15	-0.08	-0.14	0.01	-0.18	-0.28*	-0.16	-0.17	
Constant	2.55*	1.00	1.09	2.24	-0.74	0.18	2.02	-4.23	1.93	
Mcfadden's R-Square	6.53%	11.76%	12.18%	18.12%	3.75%	16.51%	8.06%	14.84%	10.99%	
Chi-square	13.58	25.15	26.1	40.2	7.7	36.27	16.9	32.26	23.5	
Regression p-value	0.25	0.00	0.00	0.00	0.74	0.00	0.11	0.00	0.01	

As regards governance structure, distressed firms with combined Chairman and CEO make acquisitions more likely. Non-executive Chairmen in turn reduces the likelihood of capital expenditure. Outside directors have little influence in the year of distress.

The control variables have varying impact on strategy choice. The external economic condition has a significant impact on several strategies. Economic downturn means less opportunity to generate cash via asset sales and hence to incur capital expenditure. Dividend cut/omission and debt restructuring, however, are more likely to be required under harsh economic conditions. Industry condition has little influence on strategy, at least in the year of distress. Where distress has resulted from firm specific internal causes, debt restructuring is more likely.

The more severely distressed firms (represented by below sample median Z scores in the distress year) are more likely to go for dividend cut/omission and debt restructuring. Finally, large companies are less likely to resort to operational restructuring and equity issue. Large firms' potentially large slack resources appear to enable them to withstand distress longer than small firms.

9.3.2 Strategy choices and their determinants- Year after distress

Regression of strategy choices made in the second year of distress are shown in Table 9.4. All logit models are significant at better than the 5% level except for operational and managerial restructuring. McFadden's R^2 ranges from 6% to 29% and for most of the models the explanatory power is much higher than

for their counterparts in the distress year in Table 9.3. Agency and control variables exercise their influence more strongly in the second year of financial distress suggesting delayed response to the onset of distress.

Lenders again influence the likelihood of debt restructuring. Inside shareholders resist equity issues in the second year. Outside shareholders continue to disfavour cash consuming acquisitions and capital expenditure. Outside shareholders also dislike asset sales that wipe out the option value of assets sold, and are also unlikely to support equity issues. However, they now appear to appreciate the need for, and support, dividend cut/omissions. CEO duality has little influence in the second year. As predicted, non-executive Chairmen make managerial restructuring less likely. Outside directors' activism emerges in the year after distress as they induce a higher probability of operational restructuring. The oversight role of outside directors does appear to intensify with length of distress.

The effects of economic downturn are significant and identical to those in the distress year except for the impact on managerial and debt restructuring. Economic downturn reduces the chances of asset sales and capital expenditure, and increases the need for dividend cut/omissions and debt restructuring. Managers are also likely to be removed when the economy is performing badly.

Table 9.4: Logistic regression of restructuring strategies on agency and control variables: Distress year +1

Coefficients of the logistic regressions of restructuring strategies on agency and control variables are shown. The dependent variable equals one if a strategy is undertaken, and zero if otherwise. The explanatory variables are based on pre-distress year's, except for economic and industry condition, which are based on current year's, figures. The sample consists of 191 distressed firms which are neither insolvent (bankrupt) nor acquired, one year post distress. Coefficients are tested for significance using the Wald test statistic. ***, **, * indicate significance at 1%, 5% and 10% respectively.

Model: Restructuring strategy = f(Debt, ownership and governance variables, and control variables)

Explanatory variables	Operational restructuring	Asset sales	Acquisition	Capital expenditure	Managerial restructuring	Dividend cut/omission	Equity issue	Debt restructuring	Cash generation
Leverage	1.68	0.94	-1.37	-0.80	0.85	1.83	0.02	7.30*	0.38
Inside shareholding	0.00	0.00	-0.01	0.00	0.00	0.00	-0.01*	-0.01	-0.01
Outside shareholding	0.01	-0.03***	-0.04***	-0.04***	0.01	0.02**	-0.02*	0.01	-0.03***
Chairman cum CEO	0.08	-0.08	0.23	0.52	-0.22	-0.48	0.31	-0.08	-0.08
Non executive Chairman	-0.23	0.01	0.17	-0.75	-1.24**	0.20	-0.43	-8.21	-0.08
Proportion of outside directors	2.11*	1.66	0.57	-0.05	-1.08	-0.51	1.17	-1.29	1.58
Economic condition	-0.11	0.31**	0.13	0.32***	-0.19**	-0.21**	0.11	-0.29	0.32***
Industry condition	-0.04	-0.17**	0.20**	0.12	0.05	-0.02	-0.04	-0.15	-0.14**
Internal problem	0.35	-0.58	-0.24	-0.14	0.83**	0.21	0.21	0.99	-0.55
Severity of distress	-0.04	0.03	0.17	0.32***	0.04	-0.25***	-0.10	-0.28**	0.02
Size	-0.13	-0.16	-0.33**	-0.12	0.15	0.04	-0.63***	0.11	-0.19
Constant	0.08	1.61	3.38**	1.96	-2.48*	-1.53	5.54***	-5.90**	2.59*
Mcfadden's R-Square	6.09%	11.95%	18.47%	28.92%	6.43%	13.82%	14.58%	15.34%	13.82%
Chi-square	11.9	24.3	38.9	65.2	12.69	28.5	30	31.8	28.5
Regression p-value	0.36	0.01	0.00	0.00	0.31	0.00	0.00	0.00	0.00

In contrast to the distress year, industry condition has significant impact on strategy choice in the second year. Industry downturn calls for more asset sales⁵⁷ and cash generative actions and a reduction in acquisitions.

After increasing the probability of debt restructuring in the distress year, internal cause of distress further increases the probability of managerial restructuring one year after distress.

Severity of distress impacts further in the second year. The more severely distressed firms are more likely to go for dividend cut/omission and debt restructuring. However, less severely distressed firms are more likely to invest internally (i.e. increase capital expenditure) in the second year. Firm size continues to influence strategy choice. Large firms are significantly less likely to raise cash via equity issue or undertake acquisitions. From the perspective of small firms, they are more likely to raise cash and make acquisitions. The need to raise cash is probably motivated by a lack of slack resources. Acquisitions, however, are more likely to be driven by the need to diversify and reduce over-reliance on existing lines of businesses. Large firms with potentially higher slack resources appear to resist such actions, at least in the year after distress.

⁵⁷As posited by Schleifer and Vishny (1992), the asset market is illiquid when the general economy, and hence the majority of firms, is not performing well. In contrast, when only the industry is in decline, firms outside the industry may still bid for assets in the declining industry, thus providing some liquidity to the industry's asset market.

9.3.3 Strategy choices and their determinants: Second year after distress

The logit models of strategy choices made in the third year of distress (distress year + 2) are shown in Table 9.5. In contrast to the models in Tables 9.3 and 9.4, only six of the third year models are significant at least at 10%. McFadden's R^2 ranges from 5% to 25%.

Lenders make dividend cut/omission more likely but surprisingly make cash generative actions less likely. Inside shareholders are joining outside shareholders in resisting acquisitions in the third year.

As regards governance structures, after two years of passive influence, dual role CEOs are more likely to adopt cash generative actions such as equity issues. Also, weak governance structure, proxied by non-executive Chairmen, is associated with unwillingness, on the part of management, to invest in capital expenditure. Outside directors are largely inactive in the third year, perhaps giving time for the benefits of earlier restructuring to show through.

The impact of external economic condition remains important. As in prior years, managers are likely to be replaced when the economy is doing poorly. Debt restructuring is also more likely during a downturn whilst capital expenditure is curtailed during a downturn. Industry condition continues to play a key role. Firms are less likely to invest by way of acquisitions when the industry condition is poor.

Table 9.5: Logistic regression of restructuring strategies on agency and control variables: Distress year +2

Coefficients of the logistic regressions of restructuring strategies on agency and control variables are shown. The dependent variable equals one if a strategy is undertaken, and zero if otherwise. The explanatory variables are based on pre-distress year's, except for economic and industry condition, which are based on current year's, figures. The sample consists of 166 distressed firms which are neither insolvent (bankrupt) nor acquired, two years post distress. The sample covers only firms in distress in the period 1985 to 1992, as firms becoming distressed in the period ending in 1993 have only one year post distress strategies to the end of the analysis period i.e. December 1994. Sample size is therefore reduced. Coefficients are tested for significance using the Wald test statistic. ***, **, * indicate significance at 1%, 5% and 10% respectively.

Model: Restructuring strategy = f(Distress debt, ownership and governance variables, and control variables)

Explanatory variables	Operational restructuring	Asset sales	Acquisition	Capital expenditure	Managerial restructuring	Dividend omission	Equity issue	Debt restructuring	Cash generation
Leverage	-1.16	-2.07	-1.71	-1.50	1.06	4.52***	-3.46	1.64	-3.25**
Inside shareholding	0.00	0.00	-0.01*	-0.01	-0.01	0.00	0.00	-0.01	-0.01
Outside shareholding	0.01	-0.01	-0.03**	-0.02	0.01	0.02	-0.01	-0.01	-0.01
Chairman cum CEO	-0.09	0.49	-0.29	0.41	0.09	-0.31	1.26**	0.88	0.77**
Non executive Chairman	-0.78	-0.19	-0.45	-1.18**	-0.22	0.08	-0.57	-0.80	-0.26
Proportion of outside directors	1.14	-0.03	-0.36	-1.41	0.10	-0.73	-2.66	-1.72	-0.66
Economic condition	-0.01	0.04	0.05	0.22**	-0.18**	-0.10	-0.12	-0.48**	-0.11
Industry condition	-0.08	-0.04	0.20**	0.03	0.03	-0.03	-0.12	-0.09	-0.06
Internal problem	0.38	0.01	0.19	-0.23	0.69	-0.36	1.36**	-0.23	0.45
Severity of distress	0.06	0.05	0.20*	0.25**	0.10	-0.27***	0.19	0.51*	0.11
Size	-0.08	-0.04	-0.10	-0.17	-0.02	-0.02	-0.05	0.45*	0.03
Constant	0.58	0.84	1.28	2.41	-1.01	-1.37	0.12	-6.87**	1.18
McFadden's R-Square	5.45%	4.65%	13.51%	24.77%	4.82%	14.34%	17.68%	12.10%	11.88%
Chi-square	9.4	7.9	24.1	47.3	8.3	25.7	32.3	21.5	20.9
Regression p-value	0.59	0.72	0.01	0.00	0.69	0.00	0.00	0.02	0.03

Where an internal problem is a cause of distress, the need to raise equity funds is increased in the second year after distress. Severely distressed firms continue to need dividend cut/omission and cut in their investments both acquisitions and capital expenditure, as a way of alleviating their financial distress. Surprisingly, debt restructuring is less likely for severely distressed firms in the second year after distress. This may be due to successful debt restructuring in the first two years. Indeed, it may be too late for severely distressed firms to restructure their debt in the third year of distress. In contrast, large firms are more inclined to restructure their debts to alleviate any financial strain in the third year. Large firms' financial slack may have allowed them to delay taking a painful debt restructuring until much later.

9.3.4 Strategy choices and their determinants: A three year summary

In Table 9.6, the results of the logit models of turnaround strategy choice reported in Tables 9.3 to 9.5 are summarised to highlight the impact of each agency or control variable on the probability of choosing or avoiding different strategies.

Impact of agency monitoring mechanisms

In Table 9.7, a comparison between the predicted impact shown in Table 4.3 and the actual impact summarised in Table 9.6 is presented. The following discussion refers to both Table 9.6 and 9.7.

Table 9.6: Summary of the effect of each explanatory variable on restructuring strategy choice [Distressed sample]

This table summarises the results in Tables 9.3 to 9.5. The multiple influences of each explanatory variable on the probability of various restructuring actions occurring are highlighted. Variables that are significantly positively/negatively related to particular strategies (i.e. increasing/decreasing the probability of those actions occurring) in the logistic regression models in Tables 9.3 to 9.5, are separately listed.

Explanatory variable	Probability of restructuring action	
	Increased	Decreased
Leverage	Dividend cut/omission Debt restructuring	Cash generative actions
Inside shareholding		Operational restructuring Acquisitions Equity issue
Outside shareholding	Dividend cut/omission	Operational restructuring Asset sales Acquisition Capital expenditure Equity issue Cash generative actions
Chairman cum CEO	Equity issues Acquisitions Cash generative actions	
Non-executive Chairman		Capital expenditure Managerial restructuring

Table 9.6: Summary of the effect of each explanatory variable on restructuring strategy choice strategies [Distressed sample](Contd.)

Explanatory variable	Probability of restructuring action	
	Increased	Decreased
Proportion of outside directors	Operational restructuring	
Economic downturn	Managerial restructuring Dividend cut/omission Debt restructuring	Asset sales Capital expenditure Cash generative actions
Industry downturn	Asset sales Cash generative actions	Acquisition Capital expenditure
Internal problem	Managerial restructuring Equity issue Debt restructuring	
Severe distress	Dividend cut/omission Debt restructuring	Acquisitions Capital expenditure Debt restructuring
Size	Debt restructuring	Operational restructuring Acquisition Equity issue

Table 9.7: Predicted and actual impact of lenders, ownership and governance on restructuring strategy choice [Distressed sample]

The table shows the predicted and actual impact of lenders, ownership and governance variables on restructuring strategy choice. The predicted impact is discussed in Section 4.3 and presented in Table 4.3 while the actual impact is summarised from Tables 9.3 to 9.5. The signs +, -, 0 denote 'favoured', 'resisted' and 'neutral' respectively.

Specific strategies	Lender		Inside shareholders		Outside shareholders		Chairman cum CEO		Non-executive Chairman		Outside directors	
	Pred.	Actual	Pred.	Actual	Pred.	Actual	Pred.	Actual	Pred.	Actual	Pred.	Actual
Operational	+	0	-	-	+	-	-	0	-	0	+	+
Asset: Divestment	+	0	-	0	-	-	-	0	-	0	+	0
Investment	-	0	+	-	-	-	+	+	+	-	+	0
Managerial Replace top management	+	0	-	0	+	0	-	0	-	-	+	0
Financial: Dividend cut/omission	+	+	-	0	-	+	-	0	-	0	+	0
Equity issue	+	0	-	-	-	-	-	+	-	0	+	0
Debt restructuring	-	+	-	0	+	0	-	0	-	0	+	0
Cash generative	+	-	-	0	-	-	-	+	-	0	+	0

As predicted, lenders prefer dividend cut/omission. Lenders are also inclined to restructure their lending. This behaviour is also observed earlier with our poor performing sample (see Section 7.3) and confirms our alternative prediction made in Section 4.3. The alternative prediction counters the general intuition that lenders would naturally prefer not to restructure debt and make sacrifices. It suggests that lenders' positive association with debt restructuring seems to prevail by definition as high leveraged firms are bound to need more debt restructuring than low leveraged ones.

Surprisingly, lenders resist cash generative actions (in the third year). It is plausible that lenders, through the debt restructuring exercise, have secured their lending on whatever worthy assets remain in the distressed firm. Since secured assets are not disposable unless with lenders' prior approval, managerial discretion over asset sales is reduced.

Inside shareholders do not favour any strategies but disfavour operational restructuring, acquisitions and equity issues. Again, this behaviour confirms earlier predictions, except for the resistance to acquisitions. The latter may be born out of inside shareholders' desire to avoid injecting new funds into the ailing firms to support acquisitions.

Outside shareholders appear to support inside shareholders in resisting operational restructuring, acquisitions and cash generative equity issues. The resistance to operational restructuring is similar to that reported earlier with the poor performing sample (see Section 7.3). However, as discussed in Section 7.2

under blockholder dominance, this resistance to operational restructuring may be premised on the cost and 'pain' of operational restructuring. Cash is often expended to meet redundancy and closure costs, putting pressure on cash flows available for dividends.

As predicted, outside shareholders also resist asset sales and cash consuming capital expenditure. Unexpectedly, they are willing to support dividend cuts/omissions. Perhaps, they consider dividend cut/omission to be less painful than subscribing to equity issues (forgoing income is better than having to throw good after potentially 'bad' money). Otherwise, outside shareholders' behaviour is largely as predicted in Section 4.3 and shown in Table 9.7.

Chairman cum CEOs favour acquisitions and cash generative equity issues. The preference for investments is as predicted. However, favouring cash generative equity issues (in the third year of distress) is quite unexpected. However, if dual CEOs are determined to keep their jobs, they may have no choice but to buy out lenders by raising equity and paying them off. Substantial asset sales at this juncture may be less feasible as any worthy assets would have been sold or charged to lenders in exchange for their continued support, thus potentially rendering equity issues necessary.

As predicted, and in spite of lenders' dominating influence during financial distress, non-executive Chairmen manage to resist managerial restructuring. However, they do go along with the idea of curbing capital expenditure, a behaviour contrary to earlier predictions. As suggested earlier, this might be the

quid pro quo for the non-executive Chairmen to protect managers from replacement. In the final analysis, a board structure with a non-executive Chairman does promote managerial entrenchment.

Outside directors do not oppose any particular strategies. However, they do favour operational restructuring, a behaviour that matches our prediction. During times of financial distress, outside directors still play an effective monitoring role in ailing firms.

Impact of control factors

Distressed firms react to deterioration in their business environment. Faced with an economic downturn, they resort to managerial and debt restructuring. Cash generative actions, however, are also more difficult in a depressed economic climate. With difficulty in raising funds, investments are also less likely in harsh economic conditions.

In contrast, when their industry as a whole experiences a downturn, declining firms are still able to pursue cash generative asset sales. Investments, both acquisitions and capital expenditure, however, are less likely during an industry downturn.

Firms with an internal cause of decline are more likely to restructure their operations, management and debt. Firms facing a severe distress would need to resort to dividend cut/omission and debt restructuring and cut down on investments. Large firms, being more resourceful, are able to refrain from

operational restructuring, and less likely to resort to equity issues. However, they are more inclined to restructure their debts, but less inclined to make acquisitions. Large firms' more diversified and international business operations necessitates more complex debt structure than small firms. Large firms are consequently more likely to restructure their debts than small firms. Unwilling to raise equity funds and preferring to renegotiate financing with creditors, large distressed firms are understandably not going to have the financial muscle to pursue acquisitions.

Joint impact of explanatory variables on strategy choice: A summary

Table 9.8 summarises the joint impact of one or more agency or control variables on the probability of choosing or avoiding a particular strategy. It answers the questions 'which factors make a given restructuring strategy more likely and which factors make it less likely?' and 'what is the coalition of stakeholders bearing on the adoption of a given strategy?'

Operational restructuring is resisted by all shareholders but favoured by outside directors. Large firms appear to have the slack resources to withstand the pressure for operational restructuring.

Asset sales are again resisted by outside shareholders. Bad economic condition also makes asset sales less likely. In contrast, poor industry condition still provides some sort of a market for asset sales.

Table 9.8: Joint impact of explanatory variables on individual restructuring strategy choice [Distressed sample]

As explanatory variables collectively influence the choice of restructuring strategies, the combined impact of explanatory variables on the choice of a specific restructuring strategy is summarised from the results reported in Tables 9.3 to 9.5. Explanatory variables that are significantly positively/negatively related to a specific strategy, in the logistic regression models in Tables 9.3 to 9.5 (i.e. increase/decrease the probability of that action occurring) are shown.

Restructuring strategy	Explanatory variables	
	Probability increasing	Probability decreasing
Operational restructuring	Proportion of outside directors	Inside shareholding Outside shareholding Size
Asset sales	Industry downturn	Outside shareholding
Acquisition	Chairman cum CEO	Economic downturn Inside shareholding Outside shareholding Industry downturn Severe distress Size
Capital expenditure		Outside shareholding Non-executive Chairman Economic downturn Industry downturn Severe distress

Table 9.8: Joint impact of explanatory variables on individual restructuring strategy choice [Distressed sample](Contd.)

Restructuring strategy	Explanatory variables	
	Probability increasing	Probability decreasing
Managerial restructuring	Internal problem	Non-executive Chairman
	Economic downturn	
Dividend cut/omission	Leverage	
	Outside shareholding	
	Economic downturn	
	Severe distress	
Equity issue	Chairman cum CEO	Inside shareholding
	Internal problem	Outside shareholding
		Size
Debt restructuring	Leverage	Severe distress
	Economic downturn	
	Internal problem	
	Severe distress	
	Size	
Cash generation	Chairman cum CEO	Leverage
	Industry downturn	Outside shareholding
		Economic downturn

Chairman cum CEO favours acquisitions although all shareholders resist it. A severe decline in performance and the existence of an industry downturn further depress the incidence of acquisitions. Large firms too disfavour acquisitions. In the case of capital expenditure, it is resisted by outside shareholders and non-executive Chairmen. Again, severe decline and industry downturn reduces the chance of incurring capital expenditure. So, would an economic downturn.

Managerial restructuring is resisted, predictably, by non-executive Chairman. However, the case for a change in leadership is enhanced when the firm decline is caused by internal factors or when the economy is facing a downturn.

Lenders' call for dividend cut/omission is supported by outside shareholders. In addition, a severe decline in performance or an industry downturn makes a cut/omission imperative.

Fund raising via equity issues is resisted by all shareholders, although the existence of an internal cause of distress makes it more likely. As discussed earlier, Chairman cum CEOs support for equity issue may be driven by their desire to raise funds and buy-out lenders. Large firms, however, appear to have the resources to refrain from making equity issues.

Lenders in highly leveraged firms have a strong impact on debt restructuring. The need for debt restructuring is amplified when the economy is facing a downturn, when the firm has an internal cause of distress or when its debt structure is complex, as proxied by firm size.

Outside shareholders and leverage jointly impact on cash generative actions. As discussed earlier, highly leveraged firms tend to have their assets secured by way of a charge to lenders, especially after a debt restructuring exercise. Hence, the ability to raise cash via asset sales is restricted.

To summarise, certain stakeholder groups seem to act in similar ways to reduce or increase the probability of certain restructuring actions. Outside directors make operational restructuring more likely whilst all shareholders make it less likely. Outside shareholders' resistance to asset sales is not countered by other stakeholders. Interestingly, the preference of Chairman cum CEO for acquisitions is contested by all shareholders. However, disapproval by outside shareholders and non-executive Chairmen of capital expenditure is unchallenged. Management entrenchment, proxied by a non-executive Chairman structure, makes managerial restructuring less likely. Dividend cut/omission is demanded by lenders and supported by outside shareholders. Chairman cum CEOs' enthusiasm for equity issues is frowned upon by all shareholders. Lenders make debt restructuring more likely. Chairman cum CEOs preference for cash generative actions are contested, surprisingly by lenders.

Our results thus reveal interesting and shifting coalitions of stakeholders vis a vis different turnaround strategies.

9.4 Impact of lender and ownership types on restructuring strategy choice

In our analysis so far we have, however, aggregated the different lender and

shareholder types. As in Section 7.4, the question then is which type of lenders and owners favour which type of strategy. To test for these individual impacts we rerun all the regressions in Tables 9.3 to 9.5 with three types of lenders instead of one, and four types of shareholders instead of two. They are short term lenders, bank lenders and unsecured lenders, and manager shareholders, manager-associated block shareholders, institutional block shareholders and non-institutional unassociated block shareholders. To maintain clarity of presentation, only the summary results are shown in Tables 9.9 to 9.10. The results of the individual logit regressions are included as Appendices 9.1 to 9.3 to this chapter. As we know from Table 6.13, there are a few correlations between leverage and shareholding variables which are moderately high. Hence, the results from the logistic regressions based on these collinear variables must be interpreted with caution. Nevertheless, they provide a significant insight into the differing impact of individual types of lenders and shareholders on firms' strategy choice during financial distress.

9.4.1 Impact of lender types

The results in Table 9.9 show that short term and unsecured lenders are the parties behind lenders' demand for dividend cut/omission. Interestingly, both short term and unsecured lenders instigate managerial restructuring in distressed firms. This was not observed in earlier regressions based on a single leverage variable.

Table 9.9: Summary of the effect of each explanatory variable on restructuring strategy choice: Individual variables [Distressed sample]

This table summarises the results in Appendices 9.1 to 9.3. The multiple influences of each explanatory variable on the probability of various restructuring actions occurring are highlighted. Variables that are significantly positively/negatively related to particular strategies (i.e. increasing/decreasing the probability of those actions occurring) in the logistic regression models in Appendices 9.1 to 9.3, are separately listed.

Explanatory variable	Probability of restructuring action	
	Increased	Decreased
Short term leverage	Managerial restructuring Dividend cut/omission Debt restructuring	Acquisition Capital expenditure
Bank leverage	Debt restructuring	Acquisition Equity issue
Unsecured leverage	Asset sales Managerial restructuring Dividend cut/omission	
Managerial shareholding		Dividend cut/omission
Institutional shareholding	Dividend cut/omission Debt restructuring	Operational restructuring Asset sales Acquisition Capital expenditure Equity issue Cash generative actions
Non-institutional unassociated shareholding	Operational restructuring	Asset sales Acquisition Capital expenditure
Chairman cum CEO	Cash generative actions	
Non executive Chairman		Capital expenditure Dividend cut/omission Managerial restructuring

Table 9.9: Summary of the effect of each explanatory variable on restructuring strategy choice: Individual variables [Distressed sample](Contd.)

Explanatory variable	Probability of restructuring action	
	Increased	Decreased
Proportion of outside directors	Operational restructuring Asset sales Cash generative actions	
Economic downturn	Operational restructuring Dividend cut/omission Managerial restructuring Debt restructuring	Asset sales Capital expenditure Cash generative actions
Industry downturn	Asset sales Equity issue Cash generative actions	Acquisition Capital expenditure
Internal problem	Operational restructuring Managerial restructuring Equity issue Debt restructuring	Asset sales
Severe distress	Dividend cut/omission Debt restructuring	Acquisition Capital expenditure
Size	Managerial restructuring Debt restructuring	Operational restructuring Asset sales Acquisition Dividend cut/omission Equity issue Cash generative actions

It suggests the need to look at the impact of lender types on strategy choice. Bank and short term lenders are behind the high probability of debt restructuring observed earlier. In addition, they now jointly restrict investments, both acquisitions and capital expenditure. Apparently, bank lenders are behind the reduced probability of cash generative equity issues. Due to unsecured lenders lack of security, they understandably prefer assets to be sold to generate cash, presumably, to fund debt repayment.

9.4.2 Impact of ownership types

Manager-shareholders alone resist dividend cut/omission, a behaviour not observed earlier (see Tables 9.3 to 9.5). This is, however, consistent with our earlier prediction in Section 4.3 which suggests manager-owners dislike dividend cut/omission for the reason that it reduces their effective total income.

Manager-associated shareholders, on their own, have no impact on restructuring strategy choice. Also, the earlier resistance to operational restructuring, acquisitions and equity issues by inside shareholders (manager and manager-associated shareholders) is lost. In contrast to the need to look at lender types, the results provide support to our earlier focus on combined ownership variables which are not only empirically correct (as they avoid multicollinearity) but also conceptually sound. The conceptual soundness is based on intuition of combining shareholders who tends to be motivated and act in similar ways.

Institutional block shareholders and non-institutional unassociated block

shareholders jointly resist asset sales and asset investments, both acquisitions and capital expenditure. Outside shareholders' disfavour of operational restructuring appears to be borne entirely by the strong resistance from institutional block shareholders in spite of non-institutional unassociated block shareholders support for it. On the other hand, institutional block shareholders are supportive of the need for dividend cut/omission. They are, however, behind the resistance by outside shareholders to equity issues. Instead, they prefer lenders to restructure their lending to alleviate firms' financial distress.

9.4.3 Impact of other agency and control variables

As in Section 7.4, it would be interesting to know if the impact of other agency and control variables on strategy choice has changed due to the use of individual lender and ownership types in the logit regression models. The impact of dual-CEOs is weakened. Dual-CEOs increase only the occurrence of cash generative actions and no longer influence the incidence of cash-consuming acquisitions. Non-executive Chairmen now additionally resist dividend cut/omission on top of managerial restructuring and capital expenditure. Outside directors influence is also enhanced as they now make cash generative asset sales more likely.

The impact of external environment is largely as before. The exceptions are economic downturns now additionally make operational restructuring more likely. The existence of an internal problem now causes operational restructuring to be

more likely, but causes asset sales to be less likely. The difficulty in selling problem assets is not surprising. Large firms are now associated with more managerial restructuring and less with a need for cash generative asset sales.

9.4.4 Joint impact of agency and control variables

In Table 9.10, the joint impact of agency variables bearing on the adoption of a given strategy is broadly similar to earlier discussion in Section 9.3.4. However, non-institutional unassociated shareholders join outside directors in pressing for operational restructuring. Inside shareholders (manager and manager-associated shareholders) no longer reduce operational restructuring. Interestingly, the previously absent impact of lenders is now being felt.

Unsecured lenders, together with outside directors, now call for asset sales. Unsecured lenders, by virtue of their unprotected lending are naturally more keen to dispose of assets to raise cash to repay their lending than the protected secured lenders.

Dual CEO and manager-associated shareholders no longer have any impact on acquisitions. In contrast, lenders, short term and bank, now restrict acquisitions. Similarly, lenders (short term) also curb capital expenditure, joined surprisingly by non-executive Chairmen. Presumably, non-executive Chairmen have to be seen to be performing their fiduciary duties, and their support may be part of a deal for managers to keep their jobs.

Table 9.10: Joint impact of explanatory variables on restructuring strategy

choice: Individual variables [Distressed sample]

As explanatory variables collectively influence the choice of restructuring strategies, the combined impact of explanatory variables on the choice of a specific restructuring strategy is summarised from the results reported in Appendices 9.1 to 9.3. Explanatory variables that are significantly positively/negatively related to a specific strategy, in the logistic regression models in Appendices 9.1 to 9.3, increase/decrease the probability of that action occurring.

Restructuring strategy	Explanatory variables	
	Probability increasing	Probability decreasing
Operational restructuring	Non-institutional unassociated shareholding Proportion of outside directors Economic downturn Internal problem	Institutional shareholding Size
Asset sales	Unsecured leverage Proportion of outside directors Industry downturn	Institutional shareholding Non-institutional unassociated shareholding Economic downturn Internal problem Size
Acquisition		Short term leverage Bank leverage Institutional shareholding Non-institutional unassociated shareholding Industry downturn Severe distress Size
Capital expenditure		Short term leverage Institutional shareholding Non-institutional unassociated shareholding Non-executive Chairman Economic downturn Industry downturn Severe distress

Table 9.10: Joint impact of explanatory variables on restructuring strategy choice: Individual variables [Distressed sample](Contd.)

Restructuring strategy	Explanatory variables	
	Probability increasing	Probability decreasing
Managerial restructuring	Short term leverage Unsecured leverage Economic downturn Internal problem Size	Non-executive Chairman
Dividend cut/omission	Short term leverage Unsecured leverage Institutional shareholding Economic downturn Severe distress	Managerial shareholding Non-executive Chairman Size
Equity issue	Industry downturn Internal problem	Bank leverage Institutional shareholding Size
Debt restructuring	Bank leverage Institutional shareholding Economic downturn Severe distress Internal problem Size	Short term leverage
Cash generation	Proportion of outside directors Chairman cum CEO Industry downturn	Institutional shareholding Economic downturn Size

Indeed, non-executive Chairmen still decrease the likelihood of managerial restructuring, although now lenders, short term and unsecured, are increasing it. Manager-owners and non-executive Chairmen are active in resisting dividend cut/omissions. Manager-owners' behaviour is predictable, as they stand to lose income from a dividend cut/omission. Non-executive Chairmen's acquiescence to the same action is symptomatic of managerial entrenchment. Dual CEOs and manager-associated shareholders no longer have any impact on equity issues. Strangely, bank lenders make it less likely.

Institutional shareholders support debt restructuring, but short term lenders disapprove of it. Perhaps, short term lenders are not willing to make any sacrifice flowing from a debt restructuring, as they are in a stronger position than longer term lenders. In other words, they prefer their debt to be repaid soon. Outside directors now join dual CEOs to demand cash generation strategies.

9.5 Effectiveness of restructuring strategies for distressed firms

In the previous section, we have examined the impact of agency monitoring and control variables on restructuring strategy choice. In this section, we extend the investigation to cover the consequences of distressed firms adopting those restructuring strategies. We aim to find out if the strategies are instrumental to corporate recovery from distress.

As with the poorly performing sample, we test for the difference in choice, timing, and intensity of restructuring strategies between recovery and non-recovery

firms for pointers to what drives recovery. We employ logit and OLS regressions of recovery on intensity of restructuring strategies to test for the effectiveness of those strategies. Due to the choice of capturing strategies through accounting information, rather than strategy announcements, event study analysis is not feasible for the distressed sample. As discussed in Section 6.3.1, the choice of purely accounting-based definition of restructuring actions for the distressed firms is premised on two important reasons. First, the use of an accounting-based Z score computed on an accounting period basis necessitates the classification of strategies taken on the same basis. Simply, though strategy announcement is swiftly reflected in stock returns it is not speedily reflected in Z scores. Put differently, there exists a serious timing mismatch between strategy announcements (which impact upon stock returns immediately) and actual financial movements reported in accounting periods (which impact upon the Z score). Secondly, it is of great interest whether strategies extracted from accounting reports can predict changes in Z scores - based on composite accounting ratios.

As shown in Table 6.12, of the 201 sample firms examined in the earlier section, 13 which become distressed in 1993 are excluded for lack of data, and 22 became insolvent or taken over in the two post distress years. The final sample for the purpose of examining strategy effectiveness consists of 166 recovery and non-recovery firms. Recovery is defined as the reversal to positive Z score in the two years after distress (see Section 6.2.4 for definitions). Firms still in distress (firms with negative Z score) two years after distress are termed non-recovery firms (see Section 6.6.2).

9.5.1 Financial characteristics of recovery and non-recovery firms

Table 9.11 shows difference in profitability and cash flows between the recovery and non-recovery firms in the pre-distress, distress and post-distress years. Panel A of Table 9.11 shows the profitability and cash flows in the distress year for the recovery and non-recovery firms. None of the six profitability and cash flow measures are statistically different between the two groups in the distress year. Similarly, they are not significantly different in size, as measured by pre-decline year total assets. Therefore, both groups have identical financial characteristics in the distress year. But what about performance two years post-distress? Do recovery firms actually achieve real gains in operating performance vis-a-vis non-recovery firms?

Panel B of Table 9.11 shows the average of two post-distress years profitability and cash flows for the non-recovery and recovery groups. In all six measures, recovery firms outperform non-recovery ones by a very significant margin. Therefore, recovery in Z score two year post-distress is based on real gains in firms' operating performance.

Next, we explore the difference in ways in which managers of recovery and non-recovery firms go about restructuring their stricken firms. We look at the choice of strategies, their timing and intensity of implementation. Finally, we test the impact of intensity of restructuring strategies on recovery in firm performance two years post-distress.

Table 9.11 Financial characteristics of recovery and non-recovery firms**[Distressed sample]**

This table shows the financial performance of recovery and non-recovery firms before and after distress, and their size. For definitions of variables refer to Table 6.10. The difference in means is tested using the t-statistics and the non-parametric Mann-Whitney Wilcoxon tests (z stat.). ***, **, * indicate significance of 1%, 5% and 10% respectively.

Performance measures	Recovery firms Mean (%)	Non-recovery firms Mean (%)	t-stat.	z stat.
Panel A: Profitability and cash flows in the distress year				
PBIT/Sales	4.09	4.48	0.24	0.28
Earnings per share growth	8.28	10.21	1.33	1.24
Return on equity	6.87	3.22	0.66	0.87
Return on asset	8.81	9.47	0.2	0.29
PBITD/Capital employed	2.63	4.81	0.64	0.16
PBITD/Total debt	7.6	9.8	0.29	0.09
Size (£M)	356.7	441.1	0.53	0.47
Table B: Profitability and cash flows - average of two years post distress				
PBIT/Sales	6.58	0.4	3.73***	4.70***
Earnings per share growth	38.19	-8.24	4.05***	4.07***
Return on equity	13.32	6.13	1.01	2.46**
Return on asset	14.04	5.81	2.61**	3.55***
PBITD/Capital employed	7.07	0.49	1.98*	2.81***
PBITD/Total debt	33.26	-1.06	3.77***	3.86***
Sample	97	69		

9.5.2 Frequency and timing of restructuring

Table 9.12 shows the frequency and timing of restructuring strategies undertaken by recovery and non-recovery firms for three years, beginning with the distress year.

In the distress year, operational restructuring actions are taken by over 50% of firms in both groups. Heavy asset investment in terms of capital expenditure and acquisitions characterise both groups in the distress year, indicating overinvestment as a possible cause of their distress. Over a third of sample firms appear to start reducing their assets in the distress year. The only significant difference between recovery and non-recovery firms in terms of distress year strategies lies in debt restructuring. Over 10% of non-recovery firms restructure their debts whilst only 3% of recovery firms do so.

In the first year after distress, with the exception of operational restructuring and investments, restructuring intensifies, especially by non-recovery firms. Since operational restructuring is usually the first turnaround strategy to be adopted at the first sight of performance decline, it is not surprising that its importance declines as the firm sinks into distress. Put differently, a firm can only cut costs and close operations to a certain level. Acquisition and capital expenditure subside rapidly due presumably to liquidity constraints, with the exception of an increase in capital expenditure by recovery firms. However, these differences are not statistically significant.

Table 9.12: Frequency and timing of restructuring strategies by recovery and non-recovery firms: Distressed sample

This table shows the frequency (% proportion) of firms adopting specific restructuring strategies in response to distress. Operational restructuring covers cost rationalisation, layoffs, closures and integration of business units. Asset sales refer to divestment of subsidiaries, and other asset sales. Acquisitions include both full and partial acquisition of businesses. Capital expenditure refers to capital expenditure on fixed assets such as plant and machinery. Managerial restructuring refers to removal of Chairman or Chief Executive Officer. Dividend cut or omission refers to omission or reduction of cash dividends per share from pre-distress year. Equity issue covers issue of equity for cash. Debt restructuring refers to debt refinancing involving extending, converting or forgiving of debt and interest. For full definitions refer to Panel B of Table 6.1. Difference in proportions between recovery and non-recovery firms is tested using the non-parametric Mann-Whitney Wilcoxon tests. Significance of the z statistic at 1%, 5% and 10% is denoted by the symbols ***, **, * respectively. Sources: Company Reports and Accounts, Datastream International, Extel Financial News Summary and Hambro Corporate Register and Company Guide.

Restructuring strategy	Distress year				Distress year +1				Distress year +2			
	Recovery		Non		Recovery		Non		Recovery		Non	
	recovery	z-stat.	recovery	z-stat.	recovery	z-stat.	recovery	z-stat.	recovery	z-stat.	recovery	z-stat.
Operational restructuring	57.7	52.2	0.7	35.1	49.3	1.83*	28.9	43.5	1.94*	43.5	1.94*	
Asset sales	38.1	34.8	0.4	40.2	43.5	0.4	41.2	42.0	0.1	42.0	0.1	
Acquisition	46.4	53.6	0.9	34.0	30.4	0.5	32.0	27.5	0.6	27.5	0.6	
Capital expenditure	49.5	56.5	0.9	54.6	43.5	1.4	47.4	36.2	1.4	36.2	1.4	
Managerial restructuring	21.8	30.4	0.6	27.8	31.9	0.6	22.7	30.4	1.1	30.4	1.1	
Dividend cut/omission	26.8	33.3	1.3	30.9	52.2	2.75***	28.9	63.8	4.46***	63.8	4.46***	
Equity issue	15.5	23.2	1.3	22.7	27.5	0.7	19.6	8.7	1.93*	8.7	1.93*	
Debt restructuring	3.1	10.1	1.89*	3.1	14.5	2.69***	2.1	13.0	2.75***	13.0	2.75***	
Cash generative actions	46.4	46.4	0.0	48.4	50.7	0.3	50.5	44.9	0.7	44.9	0.7	
Sample size	97	69		97	69		97	69		97	69	

In the first year after distress, operational restructuring, dividend cut/omissions and debt restructuring are carried out by a significantly higher percentage of non-recovery firms than recovery firms. This trend is repeated in the second year after distress. The results clearly refute any suggestion (see Section 5.6) that managers of non-recovery firms are inactive and sit on their backs in the wake of financial distress.

Managerial inaction is not an apparent cause of non-recovery as non-recovery firm managers restructure more intensively than those of recovery firms. Also, there is little timing difference as non-recovery firms do not restructure any later than recovery ones. Therefore, any suggestion that non-recovery firms do not respond swiftly to distress is unsubstantiated.

9.5.3 Intensity of restructuring

Table 9.13 shows the intensity of restructuring by recovery and non-recovery firms in response to financial distress. Since intensity of managerial restructuring is not measurable from accounting information, it is not examined⁵⁸. As restructuring strategies measured by their intensity are the explanatory variables in the following effectiveness analysis, cash generative action, which is the sum of asset sales and equity issues, is excluded to avoid duplication.

⁵⁸In the poorly performing sample, it is possible to track the number of directors replaced and hence intensity of managerial restructuring because strategies are entirely news-based. However, for the distressed sample, it is not possible to track the number of directors replaced since company annual reports and accounts seldom comment on changes in directors other than resignation and reelection of directors on rotation each year.

Table 9.13: Intensity of restructuring by recovery and non-recovery firms:**Distressed sample**

This table shows the intensity of restructuring by recovery and non-recovery firms. Operational restructuring is measured by the cost of restructuring as reported in the company accounts as a proportion of pre-distress year total assets. Asset sales, acquisition and capital expenditure are measured by the cash flows expended/pre-distress year total assets. Dividend change is the change in current year dividends over dividends in the pre-distress year. Equity issue is measured by cash raised by equity issue/pre-distress year total assets. Difference in the means between recovery and non-recovery firms are tested using t and non-parametric Mann-Whitney Wilcoxon (z) tests. ***, **, * denotes significance at 1%, 5% and 10% respectively. Sources: Datastream International and Company Reports and Accounts.

Restructuring strategy	Recovery firms	Non recovery firms	Difference in means	
	Mean	Mean	t-stat	z-stat
	<u>Distress year</u>			
Operational restructuring	2.85	2.41	0.81	0.84
Asset sales	5.35	4.74	0.77	1.18
Acquisition	19.13	22.27	0.76	0.87
Capital expenditure	13.54	14.68	0.64	0.53
Dividend change	-3.05	-9.03	0.87	0.45
Equity issue	0.76	1.16	1.34	0.24
	<u>Distress year+1</u>			
Operational restructuring	1.53	2.80	2.07**	2.26**
Asset sales	8.01	10.70	1.09	0.97
Acquisition	13.09	20.78	1.32	0.05
Capital expenditure	16.80	18.64	0.47	1.22
Dividend change	2.58	-16.35	1.65	2.25**
Equity issue	5.22	9.29	1.24	0.37
	<u>Distress year + 2</u>			
Operational restructuring	1.72	3.51	1.75*	1.96**
Asset sales	9.07	14.30	1.18	0.00
Acquisition	13.12	14.74	0.34	0.99
Capital expenditure	19.55	19.80	0.04	1.09
Dividend change	16.59	-31.71	3.61***	4.67***
Equity issue	4.28	2.34	1.02	1.98**
	<u>Distress year +1 and + 2</u>			
Operational restructuring	3.48	6.95	2.55**	2.43**
Asset sales	17.28	23.25	1.09	0.83
Acquisition	27.44	31.50	0.50	0.02
Capital expenditure	36.50	39.07	0.28	0.97
Dividend change	15.99	-40.99	2.51**	3.28***
Equity issue	17.80	23.78	0.60	0.11

Intensity is measured by the cashflows generated or drained by a strategy, as a ratio of pre-distress year total assets, with the exception of dividend change where the change is related to pre-distress year dividend per share⁵⁹. Adjustments are made for outliers, ie. set to two standard deviations, so as to normalise the distributions of intensity variables.

None of the strategies is significantly different between recovery and non-recovery firms in the first year. However, one year after distress, non-recovery firms appear to restructure their operations significantly more intensively than recovery ones. This trend is continued in the second post-distress year, caused perhaps by lack of effectiveness in the previous year.

There is no significant difference in the deployment of asset sales, acquisition and capital expenditure strategies. The difference in dividend change between recovery and non-recovery firms in the first and second year after distress is highly significant. Over the two post-distress years, recovery firms increase their dividends by 16% whilst non-recovery firms slash their dividends on average by 41%.

Unquestionably, dividend cut or omission is used intensively by non-recovery firms to conserve scarce cash resources. The significantly lower levels of equity issue by non-recovery firms, two years after distress, may not be due to

⁵⁹As discussed in Section 6.4.2, the choice of pre-distress values is based on the need to avoid contamination by severity of distress. For example, more severely distressed firms by construct will tend to have larger fall in assets and dividends from the prior year. Therefore, relating say asset sales and dividend changes to prior year asset and dividend per share values, will cause such firms to show higher intensity of asset sales and dividend changes, than less severely distressed firms.

managers' lack of efforts but to lack of enthusiasm on the part of investors to support failing management teams. So, if non-recovery is not due evidently to inaction, late action or lack of intensity in actions, is poor strategy implementation the cause for non-recovery?

It is plausible that managers of recovery firms are not only doing the right things but also doing them right! We look to the logit and OLS regression results for evidence to confirm that it is not the lack of action but rather ineffective implementation of it is the cause of non-recovery.

9.5.4 Restructuring and corporate turnaround of distressed firms

As discussed in Section 6.3.2, corporate turnaround or recovery is defined as the return to positive Z score two years post-distress. As argued in Section 5.2, a direct method of examining strategy effectiveness is to test the association between restructuring strategy and the extent of corporate recovery from financial distress. This involves running logit and OLS regressions of recovery and change in Z score in the two post-distress years from the pre-distress year level⁶⁰, on two post-distress years' intensity of restructuring strategies and control variables. As discussed in Sections 6.1 and 8.5, due to the causality problem associated with restructuring in the year of distress, only post-distress restructuring is included. We therefore restrict our regression of recovery on strategies to those taken in the two years after distress.

⁶⁰Since recovery is measured by the return to pre-distress performance i.e. positive Z score, the extent of recovery is therefore the difference in Z score two years post-distress from the pre-distress year's Z score.

Table 9.14 shows the logit and OLS regressions of recovery and the Z score two years after distress on two year post-distress intensity of restructuring strategies and control variables. As the outcome of restructuring is recovery or non-recovery, logit regression in Table 9.14 measures the impact of explanatory variables on the likelihood of a firm recovering or not recovering. OLS regressions complement the logit regression by capturing the magnitude of recovery as represented by change in Z score two years post-distress from the pre-distress year.

The signs of coefficients in both logit and OLS regressions are quite similar. The R^2 of both regressions is reasonably good, indicating that restructuring strategies and the control variables explain a significant part of the recovery story.

Higher intensity of operational restructuring appears to be associated negatively, rather than positively, with Z score changes. This confirms results in Chapter 8, which suggest that higher intensity accompanies lack of effectiveness in implementation.

As with poor performing firms (see Section 8.6), dividend change is positively related to recovery. In other words, non-recovery firms cut/omit dividends, whilst recovery ones increase it. It appears that firms in general do not use dividend cut/omission promptly as a recovery strategy to conserve cash during financial distress, but rather as a strategy of last resort when restructuring is not working and non-recovery imminent. Likewise, debt restructuring also appears to be a strategy of last resort, as it is negatively related to corporate recovery.

Table 9.14 Logit and OLS regressions of recovery and change in Z score two years post-distress from the pre-distress year, on intensity of restructuring strategies and control variables [Distressed sample]

Coefficients of the logistic and OLS regressions of recovery and change in Z score two years post-distress from the pre-distress year, on two year post-distress intensity of restructuring strategies and control variables are shown. For definitions, see Tables 6.2 to 6.3. Industry condition is represented by the Z score of median firm in the distressed firm's industry sector. Since Z score is a one year score, two variables are therefore required to proxy for industry condition two years post-distress. Coefficients are tested for significance using the Wald / t-test statistic. Regression p values are shown to indicate significance.

Model: Recovery = f(Operational, asset, managerial and financial restructuring intensity, and control variables)

	Model 1		Model 2	
	Logit regression		OLS regression	
	Coeff.	p	Coeff.	p
Operational restructuring	-3.33	0.17	-11.90	0.03
Asset sales	-0.50	0.55	-1.88	0.31
Acquisitions	-0.43	0.40	-1.42	0.20
Capital expenditure	0.30	0.58	-0.08	0.94
Managerial restructuring	-0.03	0.93	-0.15	0.85
Dividend change	0.31	0.07	0.62	0.08
Equity issue	-0.17	0.68	0.29	0.75
Debt restructuring	-1.56	0.02	-6.08	0.00
Internal cause of distress	0.35	0.43	1.02	0.28
Severity of distress	0.16	0.13	0.47	0.03
Firm size	0.05	0.67	0.15	0.56
Economic condition post-distress	0.01	0.87	0.13	0.25
Industry condition- one year post-distress	-0.10	0.35	-0.11	0.63
Industry condition- two year post-distress	0.11	0.25	-0.08	0.71
Constant	0.46	0.75	-1.69	0.59
McFadden's R-Square /Adj R ²	16.9%		25.7%	
Chi-square / F statistic	30.60		5.05	
Regression p-value	0.00		0.00	

Therefore, both dividend cut/omission and debt restructuring are potentially caused by poor crisis management on the part of non-recovery firms' managers. Less severely distressed firms are more successful in regaining their pre-distress level of Z score, two years after distress.

From the earlier frequency and intensity analysis, asset sales appear to be very much the broad strategy adopted by both groups, perhaps, resulting in a lack of significance in explaining recovery. Overall, there is no evidence that lack of restructuring efforts is a cause of non-recovery. Instead, non-recovery appears more likely to be caused by ineffective strategy implementation.

As discussed in Section 8.5, there appears, from the regression results, that there may be a potential causality problem, in that the cause and effect of strategies may be indeterminable. In other words, a strategy may be triggered by the decline or the strategy itself may have caused the decline. For example, adopting operational restructuring as a turnaround strategy means it is triggered by the financial distress. However, poor initial operational restructuring may necessitate further rounds of operational restructuring. The initial poor restructuring thus becomes a cause of further decline and distress. Therefore, conclusions cannot be drawn solely on the regression results but rather interpreted in conjunction with the frequency, timing and intensity results.

9.6 Summary and conclusion

Managers in firms that experience financial distress may choose a variety of

alternative methods of restructuring them to restore their financial health. However, managerial choices are constrained by agency monitoring and are determined by the complex interplay of the ownership structure, corporate governance and lender monitoring of the firms in distress.

Our results, from examining 201 distressed firms, show that turnaround strategy choices in distressed firms are indeed significantly influenced by both agency monitoring and control variables. The demand to curtail cash consuming acquisitions and capital expenditure by lenders, outside or unassociated blockholders and non-executive Chairmen appears predictable and uncontroversial.

However, lenders' preferences are countered by non-executive Chairmen, in the case of top management replacement, and by outside blockholders, in the case of asset sales. Manager-shareholders are largely inactive, perhaps reflecting their lack of influence when firms sink into distress. However, they join non-executive Chairmen in resisting equity issues which inevitably require financial commitment and sacrifices from them as shareholders. Outside block shareholders oppose cash consuming actions as well as cash generative asset sales and equity issue. Outside directors play an important role in distressed firms. They induce more operational restructuring and press for swift cash generative asset sales.

Based on examining 166 distressed firms for effectiveness of turnaround strategies, we find no support for managerial inaction as a cause of non-recovery from financial distress. Instead of sitting on their backs, managers of non-recovery firms often appear to take relatively vigorous restructuring actions. The evidence also

does not support timing as a cause of non-recovery, as similar proportions of recovery and non-recovery firms appear to restructure their operations in the distress year and in the following two years. In fact, more non-recovery firms restructure their operations, cut/omit dividends, raise equity and restructure their debts. Non-recovery firms also appear to restructure their operations and cut dividends more intensively than recovery firms. However, higher restructuring intensity by non-recovery firms appears to be necessitated by failure of earlier post-distress strategy implementation. Failure of strategy implementation is supported by logit and OLS regression results which show higher levels of operational and debt restructuring, and dividend cuts to be associated with lower probability of recovery.

In conclusion, intensive adoption of prescribed restructuring strategies is a necessary but insufficient condition for corporate recovery from financial distress. Effective strategy implementation appears to be the key to corporate turnaround. Corporate managers in non-recovery firms appear to lack the requisite turnaround strategy implementation skills. As with the poorly performing firms, there is potentially a case for professional turnaround managers to work in partnership with corporate managers to resuscitate ailing firms.

Appendix 9.1: Logistic regression of restructuring strategies on agency and control variables: Distress year [Individual variables]

Coefficients of the logistic regressions of restructuring strategies on agency and control variables are presented. The dependent variable equals one if a strategy is undertaken, and zero if otherwise. The explanatory variables are based on pre-distress year's, except for economic and industry condition, which are based on current year's, figures. The sample consists of 201 firms becoming distressed during the accounting periods ending in 1985 to 1993. The distress year refers to the year in which a firm's Z score declines to below zero, after two consecutive years of above zero (positive) Z score rating. Coefficients are tested for significance using the Wald test statistic. ***, **, * indicate significance at 1%, 5% and 10% respectively.

Model: Restructuring strategy = f(Pre distress debt, ownership and governance variables, and current year control variables)

Explanatory variables	Operational		Capital		Dividend cut/ Equity issue		Debt restructuring generation		Cash	
	restructuring	Asset sales	Acquisition expenditure	restructuring omission	issue	restructuring	generation	issue	restructuring	generation
Short term leverage	-2.19	-1.64	2.06	-0.62	-1.38	-1.08	0.30	-12.63*	-1.77	-1.77
Bank leverage	0.91	1.89	-2.99*	-0.60	1.20	1.79	-1.86	7.46	1.99	1.99
Unsecured leverage	1.56	-0.34	1.26	-0.76	-1.69	2.81*	1.70	4.63	-0.32	-0.32
Managerial shareholding	0.00	0.08	0.03	0.04	0.07	-0.06*	-0.01	0.77	0.02	0.02
Institutional shareholding	-0.04***	-0.04***	-0.02**	-0.03**	0.01	0.02	-0.02	0.06**	-0.03***	-0.03***
Non-institutional unassociated shareholding	0.02	-0.03*	-0.02	-0.03*	0.00	0.02	-0.02	-0.09	-0.02	-0.02
Manager-associated shareholding	-0.02	-0.07	-0.02	-0.05	-0.07	0.05	0.01	-0.78	-0.02	-0.02
Chairman cum CEO	-0.17	0.23	0.56	0.06	-0.36	-0.60	-0.08	-1.23	0.22	0.22
Non executive Chairman	-0.49	-0.02	0.55	-0.61	0.19	-1.04*	-1.33	-2.30	-0.39	-0.39
Proportion of outside directors	1.27	0.09	-0.64	-0.44	-0.48	0.13	1.09	-2.02	0.27	0.27
Economic condition	-0.16**	0.17**	0.12	0.20**	-0.03	-0.30***	0.14	-0.66**	0.16**	0.16**
Industry condition	0.00	0.03	0.05	0.04	-0.05	0.05	-0.08	-0.22	0.00	0.00
Internal problem	0.62*	-0.41	0.00	0.30	-0.28	0.35	-0.56	2.36*	-0.51	-0.51
Severity of distress	-0.01	-0.01	0.12	0.09	-0.11	-0.34***	0.06	-0.79***	0.03	0.03
Size	-0.27**	-0.16	-0.11	-0.14	0.02	-0.25*	-0.30**	-0.68	-0.19	-0.19
Constant	3.59**	1.29	1.20	2.48	-0.69	0.81	2.30	2.08	2.20	2.20
Mcfadden's R-Square	11.21%	14.04%	13.92%	19.46%	6.22%	19.79%	8.70%	20.82%	12.34%	12.34%
Chi-square	23.90	30.42	30.14	43.49	12.91	44.32	18.30	46.91	26.48	26.48
Regression p-value	0.06	0.01	0.01	0.00	0.60	0.00	0.24	0.00	0.03	0.03

Appendix 9.2: Logistic regression of restructuring strategies on agency and control variables: Distress year+1 [Combined variables]

Coefficients of the logistic regressions of restructuring strategies on agency and control variables are shown. The dependent variable equals one if a strategy is undertaken, and zero if otherwise. The explanatory variables are based on pre-distress year's, except for economic and industry condition, which are based on current year's, figures. The sample consists of 191 distressed firms which are neither insolvent (bankrupt) nor acquired, one year post distress. Coefficients are tested for significance using the Wald test statistic. ***, **, * indicate significance at 1%, 5% and 10% respectively.

Model: Restructuring strategy = f(Pre distress debt, ownership and governance variables, and current year control variables)

Explanatory variables	Operational restructuring	Asset sales	Capital expenditure	Managerial restructuring	Dividend cut/omission	Equity issue	Debt restructuring	Cash generation
Short term leverage	2.39	-1.05	-4.07	7.83***	0.65	-1.90	0.59	-2.26
Bank leverage	1.32	-2.38	1.62	-1.20	1.58	1.71	4.53*	-0.64
Unsecured leverage	1.71	2.83**	0.66	-1.67	1.64	-0.60	-1.80	1.55
Managerial shareholding	0.01	0.05	0.05	0.00	-0.04	0.00	-0.03	0.03
Institutional shareholding	-0.01	-0.02*	-0.04**	0.02	0.03**	-0.04***	0.00	-0.04***
Non-institutional unassociated shareholding	0.04**	-0.02	-0.05**	0.01	0.02	0.01	0.01	-0.02
Manager-associated shareholding	-0.01	-0.04	-0.06	0.00	0.03	-0.03	0.02	-0.04
Chairman cum CEO	0.10	-0.06	0.50	-0.33	-0.44	0.37	0.35	-0.08
Non executive Chairman	-0.27	0.02	-0.81	-1.30**	-0.04	-0.16	-8.18	0.00
Proportion of outside directors	2.61**	2.32**	0.12	-1.53	-0.22	1.03	-1.38	1.95*
Economic condition	-0.08	0.31***	0.35***	-0.21**	-0.19**	0.11	-0.26	0.32***
Industry condition	-0.04	-0.19***	0.15*	0.03	-0.03	-0.03	-0.10	-0.15**
Internal problem	0.37	-0.75*	-0.24	0.96**	0.27	0.20	0.76	-0.67
Severity of distress	-0.06	0.01	0.33***	0.02	-0.25***	-0.10	-0.29**	0.01
Size	-0.15	-0.22*	-0.19	0.30**	0.02	-0.63***	0.28	-0.25*
Constant	-0.24	2.53*	2.72	-4.50***	-1.59	5.67***	-6.68**	3.45**
Mcfadden's R-Square	11.66%	15.06%	30.97%	11.44%	16.46%	17.70%	15.78%	15.96%
Chi-square	23.69	31.17	70.80	23.20	34.34	37.20	32.80	33.22
Regression p-value	0.07	0.00	0.00	0.07	0.00	0.00	0.00	0.00

Appendix 9.3: Logistic regression of restructuring strategies on agency and control variables: Distress year+2 [Combined variables]

Coefficients of the logistic regressions of restructuring strategies on agency and control variables are shown. The dependent variable equals one if a strategy is undertaken, and zero if otherwise. The explanatory variables are based on pre-distress year's, except for economic and industry condition, which are based on current year's, figures. The sample consists of 166 distressed firms which are neither insolvent (bankrupt) nor acquired, two years post distress. The sample covers only firms in distress in the period 1985 to 1992, as firms becoming distressed in the period ending in 1993 have only one year post distress strategies to the end of the analysis period i.e. December 1994. Sample size is therefore reduced. Coefficients are tested for significance using the Wald test statistic. ***, **, * indicate significance at 1%, 5% and 10% respectively. Model: $Restructuring\ strategy = f(Pre\ distress\ debt, ownership\ and\ governance\ variables, and\ current\ year\ control\ variables)$

Explanatory variables	Operational restructuring	Asset sales	Acquisition	Capital expenditure	Managerial restructuring	Dividend cut/ omission	Equity issue	Debt restructuring	Cash generation
Short term leverage	-0.37	-1.14	-7.76***	-5.64**	-2.26	5.56**	6.67	3.59	-0.12
Bank leverage	0.16	-0.79	1.04	2.92	-1.31	2.13	-5.64*	0.96	-1.56
Unsecured leverage	1.50	0.29	1.34	-0.82	3.16*	0.60	-0.46	0.96	-0.53
Managerial shareholding	0.01	0.03	0.02	0.06	0.00	-0.01	0.00	0.94	0.03
Institutional shareholding	-0.01	-0.02	-0.04**	-0.02	0.02	0.02	-0.03	-0.05	-0.02
Non-institutional unassociated shareholding	0.04**	0.01	-0.01	-0.02	0.01	0.01	0.02	0.02	0.01
Manager-associated shareholding	-0.01	-0.03	-0.04	-0.07	-0.01	0.01	0.00	-0.96	-0.04
Chairman cum CEO	-0.10	0.46	-0.15	0.47	0.19	-0.33	0.95	0.77	0.68*
Non executive Chairman	-0.80	-0.05	-0.39	-1.14**	-0.32	-0.17	-0.37	-0.94	-0.06
Proportion of outside directors	1.33	-0.09	-0.25	-1.80	0.84	-0.45	-2.53	-1.05	-0.96
Economic condition	0.03	0.05	0.05	0.24**	-0.20**	-0.08	-0.08	-0.42**	-0.10
Industry condition	-0.08	-0.03	0.25*	0.25**	0.02	-0.05	-0.19*	-0.16	-0.06
Internal problem	0.44	0.02	0.16	-0.34	0.75*	-0.37	1.71***	-0.23	0.45
Severity of distress	0.04	0.05	0.22*	0.27**	0.11	-0.30***	0.15	0.40	0.10
Size	-0.16	-0.10	-0.24	-0.24	-0.11	0.08	-0.07	0.46*	-0.02
Constant	0.84	1.22	2.89	3.16*	0.17	-2.62	-0.54	-7.27**	1.24
McFadden's R-Square	9.13%	5.91%	17.98%	27.20%	7.19%	16.75%	20.23%	13.50%	12.34%
Chi-square	15.89	10.11	32.90	52.70	12.38	30.44	37.52	24.07	21.87
Regression p-value	0.38	0.81	0.00	0.00	0.65	0.01	0.00	0.06	0.11

Chapter 10. DETERMINANTS AND EFFECTIVENESS OF RESTRUCTURING STRATEGIES: A COMPARISON BETWEEN POORLY PERFORMING AND DISTRESSED FIRMS

10.1 Introduction

In the preceding three chapters we report and discuss the empirical results on the determinants and effectiveness of restructuring strategies by poorly performing and distressed firms. An interesting question that remains unanswered is whether the determinants of strategies are the same regardless of the level of performance decline, and whether the strategies are equally effective for firms at different stages of decline.

The objective of this chapter is therefore to compare the empirical results for the two different performance decline samples. We aim to find out if the determinants and effectiveness of strategies are similar between firms experiencing different levels of performance decline.

Specifically, we examine if different types of stakeholder dominance are associated with similar choice of strategies for the two samples. Also, we compare and contrast the individual impact and joint impact of agency and control variables on strategy choice. Finally, we compare the effectiveness of strategies in bringing about a turnaround in performance in the two sample groups.

10.2 Impact of stakeholder dominance and restructuring strategy choice

Table 10.1 summarises the impact of stakeholder dominance on strategy choice in poorly performing and distressed firms. Definitions of lender, manager-owner, blockholder, dual-CEO and board dominance are described in Section 6.5.

When firms are dominated by lenders, all restructuring strategies are intensified except for managerial restructuring. For the poor performers, dominant lenders press for operational restructuring, asset sales and equity issue to raise cash, cut/omission in dividends to conserve cash, cut in capital expenditure and restructuring of debt if actions taken are inadequate to restore ability of the firm to meet debt covenants or repayment requirements. When firms sink into distress, dominant lenders call again for dividend cut/omission and debt restructuring and reduction in all investments.

Where manager-owners form the dominant stakeholder group in poorly performing firms, they tend to disfavour investments and refrain from most actions such as operational and managerial restructuring, and cash generative asset sales and equity issues. However, when the firm becomes distressed, dominant owner-managers' influence is much reduced. They are able to resist only operational restructuring and cut/omission in dividends which harm themselves (as they hold significant shareholding in the firm) and their fellow shareholders.

Table 10.1 Stakeholder dominance and restructuring strategy choice: a comparison between poor performance and distressed samples

The table summarises the results of stakeholder dominance in Tables 7.1 and 9.1. The choice of restructuring strategies is determined by the relative bargaining powers of various stakeholders in the firm. The table compares the choice of strategy between stakeholder dominated (Yes) and non-dominated (No) groups of declining firms. Five stakeholder groups are identified - lenders, manager-owners, blockholders, CEO and board of directors. See Table 6.1 and Section 7.2 for definitions of restructuring actions and stakeholders respectively.

Dominant stakeholder	Probability of restructuring actions	
	Increased	Decreased
Lender dominated	Poorly performing	Poorly performing
	Operational restructuring Asset sales Dividend cut/omission Equity issue Debt restructuring Cash generative actions	Capital expenditure
Manager-owner dominated	Distressed	Distressed
	Dividend cut/omission Debt restructuring	Acquisitions Capital expenditure
		Operational restructuring Dividend cut/omission

Table 10.1 Stakeholder dominance and restructuring strategy choice: a comparison between poor performance and distressed samples (contd.)

		Probability of restructuring actions	
		Increased	Decreased
		Sample	
Dominant stakeholder	Poorly performing	Distressed	Poorly performing
Blockholder			Operational restructuring Asset sales Capital expenditure
Dual-CEO	Capital expenditure	Acquisitions Capital expenditure Managerial restructuring Equity issues	Managerial restructuring Dividend cut/omission
Board	Operational restructuring Asset sales Acquisition Cash generative actions		
			Distressed Asset sales Cash generative actions

When firms are dominated by external unassociated blockholders, dominant blockholders in both sample groups resist cash generative asset sales. In poorly performing firms, they also manage to resist cash consuming capital expenditure and costly operational restructuring.

When lenders, owner-managers, or blockholders are not dominant, and the Chairman is also the CEO, such dominant dual-CEOs increase the probability of investments in both sample groups. Predictably, they decrease the probability of managerial restructuring in poorly performing firms, but surprisingly increase the same in distressed firms (in the third year of distress, when dual-CEOs' resistance is weakened). When firms are in distress, dual-CEO dominant board resists dividend cut/omission. However, in the case of distressed firms, they favour equity issues.

When the firm is not dominated by lenders, owner-managers, blockholders or dual-CEOs, the board collectively dominates the firm's decision making process. In poorly performing firms, restructuring is favoured. Firms' operations are restructured, assets are sold, and acquisitions made, in order to reverse the firms' fortunes. On the contrary, such a board has little influence in distressed firms.

To summarise, in both samples, lender dominance increases restructuring actions except for cash-consuming investments. Also, when manager-owners dominate the firms decision making, they reduce the chances of firm restructuring. Blockholder-dominant firms are equivocally resistant to asset sales. More

interesting is the preference for investments and resistance to managerial restructuring in dual CEO-dominated firms across the two samples.

10.3 Impact of agency and control variables on restructuring strategy choice

In order to perform a complete comparison of the impact of individual agency and control variables between the two sample groups, we employ results from the logit regression model based on individual lender and ownership variables rather than the combined variables. Table 10.2 summarises the impact of explanatory variables on the choice of restructuring strategies in the poorly performing and distressed samples.

10.3.1 Impact of lenders

In Panel A of Table 10.2, short term creditors make turnaround strategies such as cost cutting and cash generative actions more likely in poorly performing firms. However, when firms are distressed they press for top management changes and debt restructuring, and call for a reduction in or a halt to dividend payments and acquisitions. Likewise, bank creditors make cash generative actions more likely and capital expenditure less likely in poorly performance firms. But, when firms sink into distress, they make debt restructuring more likely and acquisitions less likely. Surprisingly, bank creditors make equity issue less likely in distressed firms. As discussed in Section 9.3, it may be that high leverage distressed firms are unattractive investment propositions for equity investors. Unsecured creditors make operational restructuring and dividend cut more likely in poorly performing firms. When distress sets in they also press for asset sales and managerial restructuring.

Table 10.2: Impact of each explanatory variable on the choice of restructuring strategies: a comparison between poor performance and distressed samples

This table summarises the results in Tables 7.9 and 9.8. The multiple influences of each explanatory variable on the probability of various restructuring actions occurring are highlighted. Variables that are significantly positively/negatively related to particular strategies (i.e. increasing/decreasing the probability of those actions occurring) in the logistic regression models in Appendices 7.1 to 7.3 for the poor performers and Appendices 9.1 to 9.3 for the distressed firms, are separately listed.

Explanatory variable	Probability of restructuring action			
	Increased		Decreased	
	Poorly performing sample	Distressed sample	Poorly performing sample	Distressed sample
Panel A: Lenders				
Short term leverage	Operational restructuring	Managerial restructuring		Acquisition
	Cash generative actions	Dividend cut/omission Debt restructuring		Capital expenditure
Bank leverage	Asset sales	Debt restructuring	Capital expenditure	Acquisition
	Cash generation			Equity issue
Unsecured leverage	Operational restructuring	Asset sales		
	Dividend cut/omission	Managerial restructuring Dividend cut/omission		

Table 10.2: Impact of each explanatory variable on the choice of restructuring strategies: a comparison between poor performance and distressed samples (Contd.)

Explanatory variable	Probability of restructuring action			
	Increased		Decreased	
	Poorly performing sample	Distressed sample	Poorly performing sample	Distressed sample
Panel B: Owners				
Managerial shareholding			Operational restructuring Asset sales Acquisition Cash generative actions	Dividend cut/omission
Institutional shareholding		Dividend cut/omission Debt restructuring	Operational restructuring Asset sales Cash generative actions	Operational restructuring Asset sales Acquisition Capital expenditure Equity issue Cash generative actions
Non-institutional unassociated block shareholding	Managerial restructuring Dividend cut/omission	Operational restructuring	Operational restructuring Asset sales Cash generative actions	Asset sales Acquisition Capital expenditure
Manager-associated block shareholding	Acquisition Managerial restructuring			

Table 10.2: Impact of each explanatory variable on the choice of restructuring strategies: a comparison between poor performance and distressed samples (Contd.)

Explanatory variable	Probability of restructuring action			
	Increased		Decreased	
	Poorly performing sample	Distressed sample	Poorly performing sample	Distressed sample
Panel C: Governance				
Chairman cum CEO	Capital expenditure	Cash generative actions	Managerial restructuring Cash generative actions	Capital expenditure Dividend cut/omission Managerial restructuring
Non-executive Chairman	Acquisition Capital expenditure		Asset sales Cash generative actions	
Proportion of outside directors	Asset sales Acquisition Capital expenditure Managerial restructuring Cash generative actions	Operational restructuring Asset sales Cash generative actions		

Table 10.2: Impact of each explanatory variable on the choice of restructuring strategies: a comparison between poor performance and distressed samples (Contd.)

Explanatory variable	Probability of restructuring action			
	Increased		Decreased	
	Poorly performing sample	Distressed sample	Poorly performing sample	Distressed sample
Panel D: Control variables				
Economic downturn	Operational restructuring Managerial restructuring Dividend cut/omission	Operational restructuring Managerial restructuring Dividend cut/omission Debt restructuring	Asset sales Acquisition Capital expenditure Cash generative actions	Asset sales Capital expenditure Cash generative actions
Industry downturn	Capital expenditure Dividend cut/omission Managerial restructuring Debt restructuring	Asset sales Equity issues Cash generative actions	Operational restructuring Equity issue	Acquisition Capital expenditure
Internal problem	Operational restructuring Asset sales Cash generative actions	Operational restructuring Managerial restructuring Equity issue Debt restructuring	Dividend cut/omission	Asset sales
Severe decline/distress	Operational restructuring Managerial restructuring Dividend cut/omission	Debt restructuring Dividend cut/omission	Acquisition	Acquisition Capital expenditure
Size	Acquisition Capital expenditure	Managerial restructuring Debt restructuring	Operational restructuring Dividend cut/omission	Operational restructuring Asset sales Acquisition Dividend cut/omission Equity issue Cash generative actions

10.3.2 Impact of owners

In Panel B of Table 10.2, manager-shareholders in poorly performing firms are interestingly not in favour of any restructuring and they actively reduce the occurrence of operational restructuring, asset sales, acquisitions and equity issues. However, when firms are in distress, manager-shareholders appear only to be successful in resisting one restructuring action - dividend cut/omissions. This behaviour is consistent with the large shareholding of manager-shareholders. Dividend cut/omissions can have a painful effect on manager-shareholders' total income.

Institutional shareholders exhibit a similar behaviour to manager-shareholders. They disfavour costly operational restructuring and cash generative asset sales in poorly performing firms. Additionally, when firms are in distress, they further oppose cash-consuming acquisitions and capital expenditure, but seem equally determined in their refusal to stump up any new cash via equity issues. However, during distress, they go along with dividend cuts/omission but persuade lenders to restructure their lending.

Non-institutional shareholders unassociated with management display similar patterns of behaviour to institutional investors. They also dislike operational restructuring, asset sales and cash generative actions in poorly performing firms. However, they are instrumental in calling for management changes and are supportive of dividend cuts/omission. When firms are in distress, they still disfavour cash generative asset sales and cash-consuming investments but

they also insist on keeping up operational restructuring efforts. The demand for operational restructuring during distress is in contrast to their resistance to the same strategy when the firm is merely poorly performing. Presumably, such shareholders are only willing to back costly operational restructuring if it is an inevitable ie. firm in distress, strategy for a turnaround in performance to be achieved.

Shareholders associated with management lack influence on strategy choice particularly when firms sink into distress. During period of poor performance, manager-associated shareholdings are in favour of growth via acquisitions but surprisingly in a show of independence call for top management changes in the later stage of decline. However, the influence is very weak (significant at 10%).

10.3.3 Impact of corporate governance

In Panel C of Table 10.2, management entrenchment, epitomised by the combined role of Chairman and CEO, reduces the chances of managerial replacement and cash generative actions but increases the chances of capital expenditure in poor performing firms. However, in a twist of events, when firms slide into distress, Chairmen cum CEO are more inclined to adopt cash generative actions perhaps as a way to buy out encroaching lenders.

Behaviour of non-executive Chairmen resembles that of Chairmen cum CEO during a period of poor performance. They disfavour cash generative asset sales and favour investments, both acquisitions and capital expenditure. However,

with the onset of distress, they call on managers to reduce their capital expenditure. In return, non-executive Chairmen may offer to shelter managers from being replaced and support manager-owners in resisting dividend cut/omissions.

Outside directors are effective in their oversight of managers. They induce asset sales, managerial restructuring and cash generative actions in poorly performing firms, and additionally operational restructuring in distressed firms. Where the firm is merely poorly performing, they encourage investments via acquisitions and capital expenditure as recovery measures, after two years of restructuring (see Table 7.4). As predicted in Section 4.3 outside directors do not disfavour any turnaround strategies.

10.3.4 Impact of control variables

In Panel D of Table 10.2, external economic conditions, remarkably, impact upon all firms in similar ways regardless of the levels of performance decline. When economic conditions are good, firms are able to sell more assets and raise more cash, and in turn invest to reverse decline. In contrast, when economic condition is bad, firms in decline have to conduct more operational and managerial restructuring and cut/omit their dividends. Firms in distress also tend to need more debt restructuring.

Impact of industry condition is broadly dissimilar for poorly performing and distressed firms. Good industry condition calls for more operational

restructuring to improve competitiveness in poorly performing firms, it also provides the condition for acquiring more profitable outfits to reverse decline in distressed firms. When the industry is down, cash generative asset sales are made more likely for distressed firms. However, where the firm is poorly performing and the industry is down, turnaround strategies are called for to avoid a decline to distress - capital expenditure to improve competitiveness and profitability, cut or omission of dividends to conserve cash, and restructuring of both management and debt. Industry condition, however, has a mixed impact on firms' equity funds raising decision. Where the firm is poorly performing, an industry downturn makes equity issues less likely. However, if a firm is in financial distress and the industry is facing a downturn, equity issues are made more likely. Presumably, the desperate need for cash to bail out a distressed firm operating in the trough of its industry cycle, makes a rescue equity issue imperative (albeit at huge discounts).

Severity of distress has quite similar impact on both sample groups. Low severity means greater affordability for investments to reverse decline. High severity invariably means cut or omission in dividends for both sample groups. Additionally, for poorly performing firms, severe decline calls for operational and managerial restructuring. However, where the firm is in distress, severe distress inevitably means restructuring of debt.

The role of size in poorly performing and distressed firms is similar. Small firms with potentially lower levels of slack resources seem to need more operational restructuring and dividend cut/omission in both sample groups.

However, where the firms are in distress, small firms also need to conserve or raise cash more aggressively via asset sales, equity issues and cut in investments. In contrast, large distressed firms are more inclined towards managerial and debt restructuring. As discussed in Section 6.6.2 and shown in Table 6.13, large firms' strong negative association with managerial shareholding in distressed firms may have contributed to their ease to remove weakly-entrenched managers.

Summary

In summary, both lender and outside director groups are very active promoters of restructuring. Lenders generally favour cash generation and disfavour cash-consuming investments. Overall, shareholders resist costly operational restructuring and option-value destroying asset sales and financially painful equity issues. Weak governance characterised by a dual CEO or non-executive Chairman structure encourages investments, and resistance to managerial restructuring and cash generative actions. Strong governance epitomised by a high proportion of outside directors in the board of directors, lead to a high incidence of restructuring. Crucially, they do not disfavour any kind of restructuring strategy. Economic downturns increase operational and managerial restructuring and dividend cut/omissions but make cash generative actions more difficult. Industry downturns have a similar impact to economic downturns except that cash generative opportunities are no longer restricted. The existence of an internal cause of decline requires a range of remedial actions except investments. Severe decline means

more drastic restructuring and fewer investments. Large firms appear to be able to resist restructuring and afford investments except when the firm is in distress, when they readily restructure both their management and debt finance.

10.4 Joint impact of agency and control variables on restructuring strategy choice

Table 10.3 summarises the collective influence of explanatory variables on restructuring strategy choice in both poorly performing and distressed firms.

Operational restructuring

Operational restructuring is made more likely by short term and unsecured creditors in poorly performing firms. Ironically, outside non-institutional shareholders and outside directors, and not lenders, are the supporters of operational restructuring in distressed firms. Presumably, when firms sink into distress lenders are more interested in debt repayment than in the firms' long term health. Shareholders, in general, disfavour financially costly and cash draining operational restructuring in poorly performing firms but only institutional shareholders have the clout to oppose such actions in distressed firms. Economic downturn and the existence of an internal cause of decline also make operational restructuring more likely. Industry downturn (for poor performing firms only) and large firm size make operational restructuring less likely. Presumably, internal operational restructuring is a less appropriate remedy for industry downturns and large firms' slack resources may shelter them from the need to restructure their operations.

Table 10.3: Joint impact of explanatory variables on individual restructuring strategy choice: a comparison between poor performance and distressed samples

As explanatory variables collectively influence the choice of restructuring strategies, the combined impact of explanatory variables on the choice of a specific restructuring strategy is summarised from Tables 7.10 and 9.9. Explanatory variables that are significantly positively/negatively related to a specific strategy, in the logistic regression models in Appendices 7.1 to 7.3 and Appendices 9.1 to 9.3, increase/decrease the probability of that action occurring.

Restructuring strategy	Explanatory variables			
	Probability increasing		Probability decreasing	
	Poorly performing	Distressed	Poorly performing	Distressed
Operational restructuring	Short term leverage Unsecured leverage Economic downturn Internal problem Severe decline	Non-institutional unassociated shareholding Proportion of outside directors Economic downturn Internal problem	Managerial shareholding Institutional shareholding Non-institutional unassociated shareholding Industry downturn Size	Institutional shareholding Size
Asset sales	Bank leverage Proportion of outside directors Industry downturn Internal problem	Unsecured leverage Proportion of outside directors Industry downturn	Managerial shareholding Institutional shareholding Non-institutional unassociated shareholding Non-executive Chairman Economic downturn	Institutional shareholding Non-institutional unassociated shareholding Economic downturn Internal problem Size
Acquisition	Manager-associated blockholding Non-executive Chairmen Proportion of outside directors Size		Managerial shareholding Economic downturn Severe decline	Short term leverage Bank leverage Institutional shareholding Non-institutional unassociated shareholding Industry downturn Severe distress Size

Table 10.3: Joint impact of explanatory variables on individual restructuring strategy choice: a comparison between poor performance and distressed samples (contd.)

Restructuring strategy	Explanatory variables			
	Probability increasing	Probability decreasing	Poorly performing	Distressed
Capital expenditure	Distressed Chairman cum CEO Non-executive Chairman Proportion of outside directors Industry downturn Size	Distressed Bank leverage Economic downturn	Short term leverage Institutional shareholding Non-institutional unassociated shareholding Non-executive Chairman Economic downturn Industry downturn Severe distress	
Managerial restructuring	Short term leverage Unsecured leverage Economic downturn Internal problem Size	Short term leverage Unsecured leverage Economic downturn Internal problem Size	Non-institutional unassociated shareholding Manager-associated shareholding Proportion of outside directors Economic downturn Industry downturn Severe decline	Non-executive Chairman
Dividend cut/omission	Short term leverage Unsecured leverage Institutional shareholding Economic downturn Severe decline	Short term leverage Unsecured leverage Institutional shareholding Economic downturn Severe decline	Unsecured leverage Non-institutional unassociated shareholding Economic downturn Industry downturn Severe decline	Managerial shareholding Non-executive Chairman Size

Table 10.3: Joint impact of explanatory variables on individual restructuring strategy choice: a comparison between poor performance and distressed samples (contd.)

	Explanatory variables			
	Probability increasing		Probability decreasing	
	Poorly performing	Distressed	Poorly performing	Distressed
Restructuring strategy				
Equity issue		Internal problem Industry downturn	Industry downturn	Bank leverage Institutional shareholding Size
Debt restructuring	Industry downturn	Bank leverage Institutional shareholding Economic downturn Severe decline Internal problem Size		Short term leverage
Cash generation	Short term leverage Bank leverage Proportion of outside directors Internal problem	Proportion of outside directors Chairman cum CEO Industry downturn	Managerial shareholding Institutional shareholding Non-institutional unassociated shareholding Chairman cum CEO Non-executive Chairman Economic downturn	Institutional shareholding Economic downturn Size

Asset sales

The coalitions of stakeholders inducing asset sales are largely similar in the two sample groups. Lenders and outside directors are in favour whilst shareholders (and non-executive Chairmen in poorly performing firms) oppose asset sales. Asset sales are more difficult if the economy as whole is in decline than when the industry is in decline.

Acquisitions and capital expenditure

Entrenched managers, proxied by high manager-associated shareholding structure, favour investments in poorly performing firms. Also, outside directors favour investments as a recovery strategy in poorly performing firms. In contrast, when the firm sinks into distress, no stakeholder groups favour it. Generally, lenders and shareholders dislike both acquisitions and capital expenditure in both sample groups, and fewer large firms appear to invest to reverse distress. However, if the external environment is bad and the firm suffers a severe decline, investments are less likely. On the other hand, capital expenditure is required to improve efficiency and competitiveness if poorly performing firms face an industry downturn.

Managerial restructuring

Top management replacements in poorly performing firms are driven by outside directors and outside shareholders whilst short term and unsecured lenders are understandably the active campaigners in the case of distressed firms. Bad

external environment appears to cause more heads to roll in both sample groups. So do severe decline (in poorly performing firms) and the existence of an internal cause of decline (in distressed firms). Predictably, entrenched management in the form of dual CEOs (in poorly performing firms) and non-executive Chairmen (in distressed firms) also make top management replacement less likely.

Dividend cut/omission

Cash conservation in the form of dividend cut/omission is supported by lenders, particularly unsecured ones, and outside shareholders in both sample groups. Similarly, bad external environment, severe decline and small size appear to drive firms in both sample groups to resort to dividend cut/omissions. Predictably, owner-managers and non-executive Chairmen dislike such a move in distressed firms.

Equity issue

In the case of equity issue, the factors influencing it are mixed. Industry downturns make it more likely (or pressing) in distressed firms but less likely in the case of poorly performing firms. The existence of internal problems also necessitates fund raising via equity issues in distressed firms. Understandably, institutional shareholders disfavour equity issues, in order to avoid risking good money over bad investments. Surprisingly, bank lenders make equity issues less likely for distressed firms.

Debt restructuring

Higher bank creditors, institutional shareholding, the existence of an internal problem and severe distress increase the probability of a debt restructuring in distressed firms. However, only industry downturns increase the likelihood of debt restructuring in poorly performing firms (but no stakeholder disfavours it). Bad economic environment also induces more debt restructuring in distressed firms. Strangely, short term lenders dislike debt restructuring in distressed firms. Presumably such restructuring jeopardises the repayment of their debt in the short term.

Cash generative actions

Outside directors press for cash generative actions in both sample groups. Lenders are also champions of such a move in poorly performing firms, whilst Chairmen cum CEO are in favour of the same in distressed firms. The motives of Chairmen cum CEOs are likely to be the raising of cash to buy out encroaching lenders. Bad economic conditions appear to reduce the chances of cash generative actions in both sample groups. Opposition to cash generative actions comes from shareholders in both sample groups. However, Chairman cum CEO and non-executive Chairmen also have the clout to oppose such actions in poorly performing firms.

10.5 Effectiveness of restructuring strategies

In Chapter 8, we have examined the effectiveness of restructuring strategies by poorly performing firms using both the event study and regression methodology. However, for distressed firms in Chapter 9, we use only the regression methodology to assess strategy effectiveness for the simple reason that strategies are based on accounting information and not news announcements. As such, our comparison of the effectiveness of strategies between the poorly performing and distressed samples is restricted to the regression results.

Table 10.4 shows the results of logit and OLS regressions of recovery and two years' cumulative stock returns ranking/change in Z score two year post-distress from the pre-distress year, on restructuring strategies and control variables for the poorly performing/distressed sample.

As discussed in Section 8.5, the choice of company announcements for the poorly performing sample mean accounting-based capital expenditures, which are not announced separately from annual results, are excluded from the regression in the poorly performing sample.

The regression results for the distressed sample are appreciably less significant than for the poorly performing sample. The lack of association between accounting-based strategies and recovery in Z score can potentially be due to the multi-factor nature of Z score. On the other hand, the strong association between company announcement-based strategy and changes in stock returns in poorly performing firms produce the significant coefficients in Table 10.4.

Table 10.4: Logit and OLS regressions of recovery on intensity of restructuring strategies and control variables: A comparison between poor performance and distressed samples.

This table summarises Table 8.7 and Table 9.13 Coefficients of the logistic and OLS regressions of recovery and two years' cumulative stock returns ranking in the market post-distress (change in Z score two years post-distress from the pre-distress year), on restructuring strategies and control variables are shown. See Tables 6.1 to 6.3 for definitions and sources of information. Sample sizes for the poor performing and distressed samples are 188 and 166 firms respectively

	Model 1 Logit regression				Model 2 OLS regression			
	Poorly performing		Distressed		Poorly performing		Distressed	
Explanatory variable	Coeff.	p	Coeff.	p	Coeff.	p	Coeff.	p
<i>Restructuring strategy</i>								
Operational restructuring	-3.60	0.08	-3.33	0.17	-16.31	0.09	-11.90	0.03
Asset sales	-0.08	0.84	-0.50	0.55	-2.30	0.40	-1.88	0.31
Acquisitions	0.08	0.74	-0.43	0.40	0.88	0.60	-1.42	0.20
Capital expenditure			0.30	0.58			-0.08	0.94
Top management change	-0.05	0.00	-0.03	0.93	-0.26	0.00	-0.15	0.85
Dividend change	0.17	0.07	0.31	0.07	1.99	0.00	0.62	0.08
Equity issue	0.48	0.28	-0.17	0.68	5.28	0.04	0.29	0.75
Debt restructuring	-2.30	0.04	-1.56	0.02	-14.77	0.00	-6.08	0.00
<i>Control factors</i>								
Internal cause of distress	-0.09	0.87	0.35	0.43	-1.76	0.60	1.02	0.28
Severity of distress	0.02	0.53	0.16	0.13	0.29	0.28	0.47	0.03
Firm size	0.46	0.02	0.05	0.67	2.38	0.05	0.15	0.56
Economic condition	-0.02	0.73	0.01	0.87	-0.17	0.70	0.13	0.25
Industry condition	0.02	0.00			0.17	0.00		
Industry condition-1 year after distress year			-0.10	0.35			-0.11	0.63
Industry condition - 2 year after distress year			0.11	0.25			-0.08	0.71
Constants	-1.36	0.14	0.46	0.75	42.45	0.00	-1.69	0.59
McFadden's R-Square /Adj R ²	46.9%		16.9%		55.8%		25.7%	
Chi-square / F statistic	119.2		30.6		19.2		5.1	
Regression p-value	0.00		0.00		0.00		0.00	

In the logit regressions, the distress sample has and shares only two out of six significant coefficients found in the poorly performing sample. Positive change in dividends is a significant factor in driving up both stock returns and Z scores, two year post-decline. The relation between positive dividend change and Z scores exemplify the potential causality problem highlighted earlier in Section 8.6. Since recovery and not non-recovery firms can afford to raise their dividends, the positive relation between increase in dividend and Z scores (or positive change in Z scores) is unsurprising. In contrast, debt restructuring is significantly negatively related to changes in stock returns and Z scores, over two post-decline years. Debt restructuring may be viewed as a last resort and adopted too late, thereby signalling worsening recovery prospects. Top management changes have a significant impact on stock returns but not on Z scores. Similarly, control variables - size and industry condition during restructuring have a significant impact on stock returns but not on Z scores. In spite of the negative reactions to equity issue announcements, in particular by recovery firms (see table 8.5), equity issues are related to recovery in poorly performing firms.

The OLS regressions have similar results. All the significant coefficients in the logit regression plus the addition of equity issues are significant in the OLS regression for the poorly performing sample.

In the case of the distressed sample, operational restructuring and severity of distress are two new variables, on top of dividend changes and debt restructuring, significantly related to recovery in Z score. Less severely distressed

firms have understandably higher chances of returning to pre-distress level Z score than more severely distressed firms. Interestingly, the negative association between operational restructuring and recovery in Z scores is consistent with the negative association with recovery in stock returns in the poorly performing sample. However, as with the logit regressions, top management changes, equity issue, firm size and industry condition are significantly related to recovery in stock performance but not in Z scores.

10.6 Summary and conclusions

In this chapter, we set out to examine if the determinants of strategy choice and the effectiveness of restructuring strategies are the same irrespective of the level of performance decline. Specifically, we compare and contrast the empirical results discussed in Chapters 7 to 9, and highlight the similarities as well as dissimilarities in strategy determinants and effectiveness between the poorly performing and distressed samples.

The comparison reveals striking similarity in determinants of strategy choice but some differences in the impact of restructuring strategies on recovery in firms' stock return performance and Z scores.

Analysis of stakeholder dominance and strategy choice show dominant lenders to prefer most restructuring strategies but disfavour investments. Conversely, dominant owner-managers resist most restructuring where the firm is merely poor performing. However, they are only successful in resisting operational restructuring and dividend cuts/omissions where the firm is distressed. Dominant

blockholders are able to resist cash generation and cash consumption during a period of poor performance but only cash generation in a period of distress. Dual CEO dominated boards favour investments and resist managerial restructuring. Non-dual-CEO boards appear largely in favour of restructuring and oppose no strategies.

Analysis of the individual impact of agency mechanisms shows lenders to be broadly in favour of all types of restructuring except for cash consuming investments. Passive and perhaps powerless manager-shareholders in distressed firms are in stark contrast to their active counterparts in merely poorly performing firms, who resist a wide range of strategies. Overall, outside blockholders oppose most restructuring strategies except for managerial restructuring, dividend cut/omission and debt restructuring. Managerial entrenchment in form of Chairman cum CEOs' and non-executive Chairmen favours capital expenditure but disfavors managerial restructuring. Entrenched managers also dislike cash generative action when the firm is merely poorly performing, in which case they still have the clout to resist such measures. Outside directors are largely effective in their oversight role as they promote greater levels of restructuring.

The changing influences of stakeholders in promoting or opposing different strategies highlights the importance of managing the shifting coalitions between stakeholders during performance decline. Lenders and outside directors' preference for operational restructuring is opposed by all shareholders except for non-institutional unassociated shareholders in distressed firms. Similarly, lenders

and outside directors' preference for cash generative asset sales are challenged by most shareholders, and non-executive Chairmen when the firm is merely poorly performing. Investments are favoured by entrenched managers but are generally discouraged by lenders and other shareholders. The exceptions are manager-associated shareholders and outside directors support for investments as a recovery strategy during the later phase of the turnaround. Managerial restructuring is promoted by outside directors and block shareholders when the firm is poor performing but by lenders when the firm is in distress. Entrenched managers proxied by Chairman cum CEOs or non-executive Chairmen resist such an action. Dividend cut/omission is favoured by lenders and supported by outside block shareholders, but resisted by manager-owners and non-executive Chairmen. Equity issues are resisted by shareholders and inexplicably lenders in distressed firms. Institutional shareholders and lenders jointly make debt restructuring more likely in poorly performing firms. Cash generation is promoted by lenders and outside directors, but shareholders and entrenched managers resist it, except for dual CEOs' preference for it in distressed firms. When firms are in distress, only institutional investors have the clout to oppose cash-generative actions.

Restructuring strategies are able to explain a large proportion of the recovery in stock returns in the poorly performing sample but only a small albeit significant proportion of recovery in Z scores. The weaker association between strategies and Z scores is potentially due to the historical perspective of Z scores compiled based on past accounting figures, which serve best to measure the

current bankruptcy risks of firms. Put differently, the current Z score, based on accrual-based accounting numbers, is perhaps unable to fully reflect the impact of individual strategies on the firms' future cash flows. Potentially, a prospective Z score computed on the basis of the impact of future cash flows (from turnaround strategies) to current accounting numbers may register a far stronger association.

Chapter 11. CONCLUSIONS AND IMPLICATIONS

11.1 Introduction

In Chapter 1 we outlined the broad objectives of this study as the examination of the determinants of restructuring choice and the effectiveness of restructuring strategies. Also, we aimed to test the applicability and effectiveness of restructuring strategies to firms with differing levels of performance decline.

The three research questions to be explored were:

1. What are the determinants of restructuring strategy choice in response to performance decline?
2. How effective are the prescribed turnaround strategies in contributing to corporate turnaround from performance decline?
3. Are the generic turnaround strategies equally applicable to and effective for firms experiencing different degrees of performance decline?

We explored the above empirical questions with two samples of firms with different levels of performance decline - one merely poorly performing and the other in financial distress. The aim is to obtain a complete understanding of how strategy choices are made, whether they are effective, and if firms experiencing different degrees of decline react or the strategies work, differently.

We employ logit regression methodology to examine the impact of lenders, ownership, governance and control variables on firms' restructuring strategy choice. For both the poorly performing and distressed samples, we use logit and

OLS regressions to test strategy effectiveness via examining the association between intensity of post-decline restructuring to post-decline recovery in performance. Additionally, for the poorly performing sample, we use the event study methodology to measure the effect on shareholders' wealth of strategy announcements, as a complementary measure of strategy effectiveness.

The samples consist 297 poorly performing and 201 distressed firms. The samples are reduced to 188 and 166 firms respectively for the two groups, in examining strategy effectiveness two years post decline.

In the following sections, we summarise the results of our empirical analysis with regard to the objectives we set out earlier, and discuss the implications of these results for corporate managers, lenders, shareholders, and governance policy makers. Areas for further research are also suggested.

11.2 Determinants of restructuring strategy choice

In Chapters 7 and 9, we empirically examine the determinants of restructuring strategy choice, for a sample of poorly performing and a sample of distressed firms, applying a comprehensive strategy determinants framework. Logistic regressions are employed to test the impact of a range of explanatory variables on strategy choices. The results provide interesting new insights into managers' strategy selection process. In this respect, we consider we have succeeded in our first objective of understanding what factors induce managers to choose or avoid certain restructuring strategies in the wake of performance

decline.

Our results confirm that the different, and often conflicting, welfare implications for different stakeholders resulting from recovery strategies cause managers' choice of recovery strategies to be determined by a complex interplay of the ownership structure, corporate governance and lender monitoring of the firms in decline. There is also evidence of shifting coalitions among lenders, managers and directors in the choice of recovery strategies.

The results have practical implications for lenders, managers, shareholders, outside directors and policy makers.

Lenders

The benefits of lender monitoring are evident in the poorly performing sample. Lender-dominated firms are more likely to opt for operational restructuring and are less likely to approve of a cash-consuming strategy such as capital expenditure. Lenders' insistence on operational restructuring, aimed at 'stopping the bleeding' or 'avoiding cash haemorrhage', can be value-enhancing in the long run. Operational restructuring actions such as layoffs, closures and integration of facilities are often associated with large charges against earnings and cash outflow in the short term, but they can reduce costs and increase profitability and cash outflows in the long run. Also, the beneficial effects of lender monitoring are felt in distressed firms, as well as poorly performing ones. For instance, lenders' insistence on strict financial control, evidenced by restriction on capital

expenditure, helps to conserve scarce cash resources, and avoid corporate failure.

On the other hand, lenders tight financial reign through discouraging investments can cause an under-investment problem in both poor performing and distressed samples. Lenders may not only be depriving firms of vital resources necessary to compete and reverse decline but also weaken their strategic health by favouring short term cash generative measures to facilitate debt repayment. Also, lenders' strong preference for cash generative actions in spite of disapproval from shareholders pose the question whether lenders wield excessive power. Indeed, the results reveal some potentially detrimental effects of lender dominance. It raises the question whether banks are unwittingly too keen to pull the plug on ailing firms which lack short term cash generation ability in spite of their healthy long term potential.

In respect of the excessive powers of lenders, policy makers are attempting to revamp the 1986 Insolvency Act. The current debate centres on removing the floating charge or at least curtailing the rights of floating charge holders in the event of a firm sinking into financial distress i.e. unable to service debt obligations as they fall due or breaching key debt covenants. A floating charge holder has powers even surpassing those of fixed charge holders (see Appendix 2.1). Although fixed charge holders can seize the assets being charged to them, in the event of a default, they have no powers of management, as opposed to floating charge holders. In other words, only floating charge holders have the right, without court approval, to appoint an administrative receiver to manage the firm's

operations. UK banks generally require both a fixed and floating charge for substantial lending.

Removal of floating charge may have a significant impact on how firms are managed in a turnaround situation and how lending is structured. Corporates' freedom from the clutch of lenders may be gained at a high cost, as lenders will inevitably seek higher returns from the much riskier no-floating charge lending. A compromise may lie in curtailing the rights of floating charge holders. Instead of an outright ability to appoint an administrative receiver, they will need prior court approval. In this scenario, other affected parties and the distressed firm's managers in particular are able to present their own views and restructuring proposals.

A new 'Insolvency Act' which curbs some of the excess powers conferred on lenders may ease the financial hardship faced by turnaround managers. Perhaps, through reduced pressure to liquidate assets and reduce debts, turnaround managers can focus on achieving survival and long term profitability in the firms' chosen product/markets. Corporate failures which may result from lenders desire to take control and liquidate assets to repay themselves, may potentially be reduced.

On the other hand, there are undoubtedly significant benefits flowing from lender monitoring in poor performing and distressed firms. Indeed, announcement of debt issue is viewed positively by the stock market, linked to the reduction of agency costs flowing from lender monitoring (James, 1987). Therefore, to

continue to incentivise lenders to perform such monitoring, sacrifices must continue to be made by other stakeholders, such as the present granting of top priority rights to lenders.

Managers

With regard to managers, in the case of poorly performing firms, the results imply that when they call the shots e.g. when governance structure is weak as proxied by a dual CEO and non-executive Chairman structure, they tend to pursue self-serving interests which result in less restructuring and top management replacement. Also, excessively high managerial shareholding and control are shown to cause managerial inertia and inaction vis a vis performance decline. Entrenched managers' resistance to restructuring can push the firm down a spiral to failure and should therefore be curtailed. However, in the case of distressed firms, manager shareholders are largely inactive, reflecting their eroded influence when firms have sunk into distress.

Shareholders

In the case of shareholders in the poorly performing sample, the results imply that non-institutional rather than institutional shareholders are active monitors, evidenced by their influence in instituting top management changes and dividend cuts/omissions. This difference in behaviour may stem from short-termism on the part of institutional investors. Unlike non-institutional blockholders

who generally make a strategic investment in the ailing firm, institutional investors have been accused of cutting their losses and selling out on the first sight of financial trouble (Pound, 1988). The reluctance in initiating management changes brings to question the independence and commitment of institutional shareholders. Institutional shareholders' behaviour is symptomatic of Pound's (1988) argument of a less effective monitoring role for institutional shareholders. Specifically, he argues that institutional shareholders' other business dealings with the company e.g. underwriting and broking, may lead to a conflict of interest detracting from effective monitoring. In other words, large institutions may possibly have compromised their monitoring obligations by their close working relation with ailing corporates who provide them with vital underwriting or other professional income. However, the tight City regulatory regime covering the erection of 'Chinese Walls' between the broking and underwriting and the investment side of large institutions makes such an allegation difficult to prove. Overall, outside shareholders do generally seem to go along with management shareholders on strategy choice except for investments and managerial restructuring.

However, shareholders' general reluctance to support any type of financially costly strategy such as operational restructuring or option value-destroying strategies such as asset sales looks worrying. The evidence implies that shareholders' short-termist view may drive UK corporates to focus on short term profit objectives and targets. The remedy, therefore, lies in persuading investors to take a more long term view of corporate investments. In this respect, the train

is set in motion, recently, with institutional investors beginning to press for key changes in the corporate governance of their investee firms.

Corporate governance

The Cadbury Report on the Financial Aspects of Corporate Governance (the Code) is the most authoritative report on corporate governance at the time of writing. It emphasises checks and balances within the structure of a company, especially at the board level which assists directors in fulfilling their duty to act in the interests of the company and guard against undue concentration of power among top managers. Paragraph 1.2 of the Code says that there should be a clearly accepted division of responsibilities at the head of a company which will ensure a balance of power and authority such that no one has unfettered powers of decision. The report says that the calibre and number of non-executive directors should be such that they carry significant weight in the board's decisions, and that they should be independent. However, the report does not lay down the proportion of non-executive directors in the board. The argument put forward is that it is the quality of the non-executives that counts and not the numbers.

The implication of our empirical results for both samples on the role of outside or non-executive directors are highly interesting. Boards with a large outside director presence are shown to be effective in their oversight of managers, as they intensify adoption of many turnaround strategies. This implies strong support for the Cadbury code of practice.

However, the Cadbury's code of best practice may perhaps be inadequate in the light of our results. The power and beneficial impact of outside director monitoring appears to lie in numbers. The threat of significant numbers of non-executives revolting against (and potentially voting out) executive directors, exerts tremendous pressure on executives to behave properly. Hence the lack of a recommended minimum number of non-executive directors or a proportion of non-executive directors in the board of directors may reduce substantially the real impact of non-executives, in particular, on firms' strategic decisions during a critical period of performance decline.

The results from both samples have even more serious implications for the role of Chairmen and CEOs. When both roles are combined, the results show detrimental effects. Entrenched Chairmen cum CEOs refrain from taking managerial restructuring and cash generative actions, and favour investments. It implies that dual CEOs are more interested in empire building, or at least in maintaining it, during period of performance decline, when serious restructuring efforts are necessary for recovery. In this respect, the Cadbury code of practice fails to call explicitly for the separation in the role of Chairman and Chief Executive Officer. However, although the report does not explicitly call for the separation of the posts of chairman and chief executive, the report does clearly emphasise that in principle they should be. The jury is still out on whether the weak suggestion for a separation of the chairman and chief executive positions has any persuasion at all, in practice.

Also, the results highlight the crucial role board Chairmen play in corporate governance in poorly performing and distressed firms. Part time non-executive Chairmen's tendency to promote strategies similar to those favoured by a Chairman cum CEO structure implies that an 'outside' Chairman furthers managerial entrenchment. An executive Chairman, essentially, not only ensures division of power at the corporate head i.e. roles of Chairman and CEO are separate, but also ensures 'mutual monitoring' of actions between the Chairman and CEO from the 'inside'. Consequently, when the Chairman is in a non-executive capacity, monitoring from the inside is absent, leaving the CEO to wield supreme control over the firm. In this regard, the Cadbury code fails again to emphasise the need for full-time Chairmen to play the vital role of an informed 'inside' board monitor.

Control factors

In addition, our results show significant impact from previously ignored control factors on strategy choice. Specifically, the external economic and industry conditions influence significantly the availability and attractiveness of, and the need for, certain strategies. Firm size, severity of decline and internal cause of decline also impact significantly on restructuring strategy choice. Large firms appear to have the financial slack to withstand decline better. This reflect financial strength to weather the storm with no cash constraints in terms of investing for strategic change. Managers of poorly performing large firms are better able to steer

their firms back to recovery than managers of smaller firms. Firms suffering from severe decline or severe financial distress, are observed to need greater levels of restructuring than their less severely afflicted counterparts. Firms reporting an internal cause of decline also restructure more intensively, in particular, through internal operational restructuring, and interestingly, managerial restructuring.

The importance of controlling for contextual factors implies that results from the only other study of this nature by Ofek (1993), which ignores such influences, have to be interpreted cautiously. Also, results from past related studies employing less comprehensive determinants models may be potentially flawed due to the problem of omitted variables.

Potentially, corporate failures can be explained by poor agency monitoring during decline, resulting in poor choice of appropriate turnaround strategies.

11.3 Effectiveness of restructuring strategies and corporate turnaround

In Chapters 8 and 9, we examine the frequency of recovery and non-recovery by firms adopting the prescribed strategies. We investigate the timing, intensity and shareholder wealth impact of restructuring strategies (in the case of poorly performing firms). We also run regressions to test the impact of intensity of restructuring strategies on recovery from performance decline. In this context, we have augmented our understanding of whether restructuring strategies are effective in contributing to corporate turnaround from performance decline.

For the poorly performing sample, the results show asset and managerial

restructuring to be effective and operational and financial restructuring to be ineffective. Our results suggest that the root cause of non-recovery is bad implementation of restructuring strategies and not their timing or intensity. For similar strategies, non-recovery firms' managers are perceived by the market to be far less effective in their implementation.

Our results for both samples show no support for managerial inaction as a cause of non-recovery from decline. Instead of sitting on their backs, managers of non-recovery firms appear to take apparently vigorous and intensive restructuring actions. The evidence also does not support timing as a cause of non-recovery, as similar proportions of recovery and non-recovery firms appear to restructure their operations in the distress year and in the following two years. In fact more non-recovery firms restructure their operations, cut/omit dividends, raise equity and restructure their debts earlier. Non-recovery firms also appear to restructure their operations and cut dividends more intensively in the later years of decline/distress than recovery firms. However, higher restructuring intensity by non-recovery firms appears to be necessitated by failure of earlier strategy implementation. This is supported by logit and OLS regression results which show higher levels of operational and debt restructuring, and dividend cuts/omissions to be associated with lower probability of recovery.

The results have major implications for managers and shareholders. Managers must recognise that half hearted attempts at implementing restructuring strategies are seen through by investors at large. Hence, appearing to be

restructuring is insufficient to convince the stock market. Rather, managers must be seen to be carrying out the restructuring credibly and seriously. Taking a different perspective, the root of managers poor strategy implementation may lie in corporate managers being, generally, poor 'turnaround' managers. Hence, there may be a case for engaging professional turnaround managers to work in partnership with corporate managers to resuscitate ailing firms.

For shareholders, it implies that they can take comfort from the fact that the UK stock market is efficient, and prices correctly reflect the impact of information about the effectiveness of strategies released to the market, as they arise. The stock market appears to interpret restructuring announcements correctly as pointers to eventual recovery or non-recovery.

In conclusion, timely and intensive adoption of prescribed restructuring strategies is an insufficient condition for corporate recovery from poor performance. Effective strategy implementation appears to be the key to corporate turnaround.

11.4 Determinants and effectiveness of restructuring strategy choice: A comparison between poorly performing and distressed firms

In chapter 10, we set out to examine whether the determinants of strategy choice and the effectiveness of restructuring strategies are the same irrespective of the level of performance decline. In this respect, we have succeeded in our third objective of understanding whether the same turnaround strategies are equally

applicable to and effective for both poorly performing and distressed firms.

The results reveal a striking similarity in the determinants of strategy choice but some differences in the impact of restructuring strategies on recovery in firms' stock performance and Z scores.

Impact of lenders

The role of lenders is similar in both poorly performing and distressed firms. Lenders are generally in favour of all restructuring except for cash consuming investments. However, lenders are only able to instigate management changes when firm performance has reached distress level.

Impact of ownership

Manager-shareholders' passive and somewhat powerless behaviour in distressed firms is in stark contrast to the activism of their counterparts in poorly performing firms. Dominant owner-managers prefer investment and growth and resist most other restructuring where the firm is merely poor performing. However, they are only successful in resisting operational restructuring and dividend cuts/omissions where the firm is distressed. This shows the influence of manager-shareholders diminishes as firms sink deeper into distress.

Outside blockholders oppose most restructuring strategies except for managerial restructuring, dividend cut/omission and debt restructuring. Dominant blockholders resist cash generation and cash consumption during period of poor

performance but only cash generative actions during period of financial distress. Hence, the importance of outside blockholders to restructuring strategies changes with the level of performance decline.

Impact of corporate governance

Managerial entrenchment in the form of Chairman cum CEO and non-executive Chairman favours capital expenditure but disfavours managerial restructuring. Chairmen cum CEO and non-executive Chairmen also dislike cash generative action except when the firm is distressed, in which case cash generation is imperative. Dual-CEO dominated firms also favour investments and make top management changes less likely. The results thus confirm the detrimental effects of managerial entrenchment, proxied by the existence of Chairman cum CEO and non-executive Chairman, irrespective of the firm's level of performance decline.

Outside directors are largely effective in their oversight role as they promote greater levels of restructuring. The efficacy of outside directors and their impact on restructuring strategy choice is similar at all levels of performance decline.

Effectiveness of restructuring strategies

The difference, if any, in the effectiveness of restructuring strategies between poorly performing and distressed firms is difficult to measure due to absence of shareholder wealth impact analysis of strategy announcements for the

distressed sample. However, based on the results of the logit and OLS regressions of recovery in stock returns/Z score on intensity of restructuring strategies and control factors, we observe a number of similarities and dissimilarities.

The distressed and the poorly performing samples report the same unfavourable impact from operational restructuring, dividend changes and debt restructuring on recovery. However, the favourable impact of equity issue, firm size and industry condition experienced by the poorly performing sample is not felt with the distressed sample. This contrast is likely to be caused by the difference in performance measures between the two samples. The use of stock returns for the poorly performing sample to measure recovery invariably shows a close association between recovery and equity issues and the returns of the firms FTA industry sector.

Restructuring strategies are able to explain a large proportion of the recovery in stock returns in the poorly performing sample but a smaller but significant proportion of recovery in Z scores. The weaker association between strategies and Z scores is potentially due to the historical orientation of Z scores - compiled based on past accounting figures, which serve best to measure the current financial health and bankruptcy risks of firms. Put differently, the current Z score, based on accrual-based accounting numbers, is perhaps unable to fully reflect the impact of individual strategies on the firms' future cash flows. Perhaps, a prospective Z score computed on the basis of the impact of future cash flows (from turnaround strategies) to current accounting numbers may register a far

stronger association.

11.5 Issues for further research

While this study has identified an interesting range of influences on strategy choice - debt, ownership, governance and control factors, our logit regression methodology is successful only in capturing the individual and joint impact of explanatory variables on restructuring strategy choice. However, there may exist potential or latent variables in the form of complex interactions between explanatory variables, which have not been unexplored. More sophisticated tests on the complex interactions between the various agency factors may be possible with tools such as LISREL which are claimed to be designed for such tests.

This study provides vital new insights into the effectiveness of restructuring strategies in bringing about a swift turnaround in performance two years after decline/distress. However, the impact of strategies may take longer than two years to show through, and therefore the impact of strategies on long term recovery may differ from that on medium term recovery from performance decline. This limitation is more applicable to the distressed sample as Z score measures the bankruptcy risk of a firm at the balance sheet date and does not reflect the future impact of recently implemented strategies. In contrast, the use of a leading indicator i.e. stock return, which captures the expected future cashflows deriving from all strategies implemented to date in the poorly performing sample mitigates this problem.

Leading on from the effectiveness issue, our results show that the root cause of non-recovery lies, for the average sample firm, not in choice, timing or intensity of strategy but poor implementation. Consequently, blind and intensive adoption of prescribed restructuring strategies is inadequate, and the focus should therefore be put on implementing strategy correctly and credibly. However, we have not explored the micro-structure of the implementation process such as the organisational and cultural parameters of change and show the factors aiding or impeding the successful implementation of restructuring strategies. In this respect, case-study analysis of a sample of successful and failed turnaround firms should reveal the details of how reported strategies are conceived and the factors aiding or impeding the process of implementation, and the true eventual success or failure of strategies. Due to the need to identify the exact timing of implementation or announcement of strategy, such an approach may only be practicable for firms in the poorly performing sample.

BIBLIOGRAPHY

Abarbanell, J. S. and V. Bernard (1992). 'Tests of analyst's overreaction/under reaction to earnings information as an explanation for anomalous stock price behaviour', *Journal of Finance*, July, pp. 1181-1207.

Afshar, K., R. J. Taffler and P. S. Sudarsanam (1992). 'The effect of corporate divestments on shareholder wealth: The UK evidence', *Journal of Banking and Finance*, 16, pp. 115-135.

Agrawal, A. and G. Mandelker (1990). 'Large shareholders and the monitoring of managers: The case of antitakeover charter amendments', *Journal of Financial and Quantitative Analysis*, Vol. 25, No 2, June.

Ali, A. and A. Klein (1994). 'A second look at the negative earnings effect', *The Journal of Portfolio Management*, Summer, pp. 41-50.

Altman, E. I. (1968). 'Financial ratios, discriminate analysis and the prediction of corporate bankruptcy', *Journal of Finance*, 23, pp. 589-609.

Argenti, J (1976). 'Corporate collapse : The causes and symptoms', McGraw-Hill.

Arogyaswamy, K., V. L. Barker III and M. Yasai-Ardekani (1995). 'Firm turnarounds: An integrative two-stage model', *Journal of Management Studies*, November, pp. 491-525.

Asquith, P. and D. W. Mullins (Jr) (1983). 'The impact of initiating dividend payments on shareholders' wealth', *Journal of Business*, 56, pp. 77-96.

Asquith, P. and D. W. Mullins (Jr) (1986). 'Signalling with dividends, stock repurchases, and equity Issues', *Financial Management*, Autumn, pp 27-44.

Atkins, A. B. and E. A. Dyl (1990). 'Price reversals, bid-ask spreads, and market efficiency', *Journal of Financial and Quantitative Analysis*, December, pp. 535-548.

Aziz, A. and G. H. Lawson (1989). 'Cash flow reporting and financial distress model: Testing of hypotheses', *Financial Management*, Spring, pp 55-63.

Baden-Fuller, C.M.F. and J. M. Stopford (1992). 'Rejuvenating the mature business', Routledge, London and New York.

Bajaj, M. and A. M. Vijh (1990). 'Dividend clienteles and the information content of dividend changes', *Journal of Financial Economics*, 26, pp. 193-219.

Ball, R. and P. Brown (1968). 'An empirical evaluation of accounting income numbers', *Journal of Accounting Research*, Autumn, pp. 159-178.

Ball, R. and S. P. Kothari (1989). 'Nonstationary expected returns: implications for tests of market efficiency and serial correlations in returns', *Journal of Financial Economics*, November, pp. 51-74.

Barker, R. G. (1996), 'Financial reporting and share prices: The finance directors' view', Price Waterhouse.

Barker III, V. L. And M. A. Mone (1994). 'Retrenchment: Cause of turnaround or consequence of decline', *Strategic Management Journal*, Vol 15, pp. 395-405.

Barclay, M. and C. Holderness (1991). 'Negotiated block trades and corporate control', *Journal of Finance*, 46, pp. 861-878.

Barniv, R. and A. Raveh (1989). 'Identifying financial distress: A new nonparametric approach', *Journal of Business Finance and Accounting*, 16(3), Summer, pp 361-383.

Bathala, C. T., K. P. Moon and R. P. Rao (1994). 'Managerial ownership, debt policy, and the impact of institutional shareholdings: An agency perspective', *Financial management*, Vol. 23, No. 3, Autumn 1994, pp. 38-50.

Baysinger, B. D. and R. E. Hoskisson (1989). 'Diversification strategy and R&D intensity in large multi product firms', *Academy of Management Journal*, 32, pp. 310-322.

Baysinger, B. D. and R. E. Hoskisson (1990). 'The composition of boards of directors and strategic control: Effects on corporate strategy', *Academy of Management Review*, 15, pp. 72-87.

Beaver, W. H. (1966). 'Financial ratios as predictors of failure', *Empirical Research in Accounting: Selected Studies*, Supplement to *Journal of Accounting and Research*, Vol 4, pp. 7-111.

Beaver, W., R. Lambert and D. Morse (1980). 'The information content of security prices', *Journal of Accounting and Economics*, March 1980, pp. 3-28.

Beaver, W., R. Lambert and S. Ryan (1987). 'The information content of security prices: a second look', *Journal of Accounting and Economics*, July, pp. 139-157.

Benish. M. D. And E. Press (1993). 'Costs of technical violation of accounting-based debt covenants', *The Accounting Review*, April.

Benston, G (1966). 'Published Corporate Accounting Data and Stock Prices', *Empirical Research in Accounting: Selected Studies 1966- Supplement to Journal of Accounting Research*, pp. 1 -14.

Benston, G (1976). 'There's no real news in earnings report', *Fortune*, April, pp. 73-75.

Bernard, V. L. and J. Thomas (1989). Post-earnings-announcement drift: Delayed price response or risk premium', *Journal of Accounting Research*, 27, Supplement, pp. 1-36.

Bernard, V. L. and J. Thomas (1990). 'Evidence that stock prices do not fully reflect the implications of current earnings for future earnings', *Journal of Accounting and Economics*, 13, pp. 305-340.

Bethel, J. E. and J. Liebeskind (1993). 'The effects of ownership structure on corporate restructuring', *Strategic Management Journal*, Vol 14, pp 15-31.

Bibeault, D. B. (1982). 'Corporate turnaround', New York, McGraw Hill.

Biteman, J (1979). 'Turnaround management: An exploratory study of rapid, total organization change', D.B.A dissertation, Harvard University.

Blackwell, D. W, M. W. Marr and M. F. Spivey (1990). 'Plant closing decisions and the market value of the firm', *Journal of Financial Economics*, 26, pp. 277-288.

Black F. and M Scholes (1974). 'The effects of dividend yield and dividend policy on common stock prices and returns, *Journal of Financial Economics*, 1, pp. 1-22.

Boeker, W. and J. Goodstein (1993). 'Performance and successor choice: The moderating effect of governance and ownership', *Academy of Management Journal*, 36, pp. 172-186.

Bonnier, K. and R. F. Bruner (1989). 'An analysis of stock price reaction to management change in distressed firms', *Journal of Accounting and Economics*, 11, pp. 95-106.

Bowman, E. D. and H. Singh (1993). 'Corporate restructuring: Reconfiguring the firm', *Strategic Management Journal*, Vol 14, pp. 5-14.

Brickley, J. A., R. C. Lease, and C. W. Smith (1988). 'Ownership structure and voting on antitakeover amendments', *Journal of Financial Economics*, 20, pp. 267-292.

Brown, D. T., C. M. James and R. M. Mooradian (1993). 'The information content of distressed restructuring involving public and private debt claims', *Journal of Financial Economics*, 33, pp. 93-118.

Brown, K. C., W. V. Harlow (1988). 'Market overreaction: Magnitude and intensity', *Journal of Portfolio Management*, Winter, pp. 6-13.

Brown, K. C., W. V. Harlow and S. M. Tinic (1990). 'How rational investors deal with uncertainty', *Journal of Applied Corporate Finance*, Fall, pp. 45-58.

Restructuring and turnaround, Business International Research Report, 1987.

Brown, S. J. and J. B. Warner (1985). 'Using daily stock returns: The case of event studies', *Journal of Financial Economics*, 14, pp. 3-31.

Cameron, K. S., R. I. Sutton and D. A. Whetten (1988). 'Issues in organisational decline'. In K. S. Cameron, R. I. Sutton and D. A. Whetten (eds.), *Readings in Organisational Decline: Frameworks, Research and Prescriptions*, Ballinger, Boston MA, pp. 3-19.

Campbell, K. and R. Limmack (1993). 'Stock market overreaction in the UK: An assessment using data from the LBS risk-measurement service', **Paper presented at the British Accounting Association Conference**, University of Strathclyde, April.

Campbell, C. and B. Underdown (1991). 'Corporate insolvency in practice: An analytical approach', Paul Chapman Publishing Ltd.

Carrington, J. H. and J. M. Aurelio (1976). 'Survival tactics for the small business', *Business Horizons*, 19, 1, Feb, pp. 13-24.

Chan, K (1988). 'On the contrarian investment strategy', **Journal of Business**, pp. 147-163.

Choi, D (1991). 'Toehold acquisitions, shareholder wealth and the market for corporate control', **Journal of Financial and Quantitative Analysis**, vol. 26, No. 3, Sep.

Citron, D. B (1992), Financial ratio covenants in UK bank loan contracts and accounting policy choice', **Accounting and Business Research**, Autumn.

Chopra, N., J. Lakonishok and J. R. Ritter (1992). 'Measuring abnormal return: Do stocks overreact?', **Journal of Financial Economics**, 31, pp 235-268.

Christie, W. G (1994). 'Are dividend omissions truly the cruellest cut of all?', **Journal of Financial and Quantitative Analysis**, Vol 29,3, September, pp. 459-480.

Clark, K. and E. Ofek (1995). 'Mergers as a means of restructuring distressed firms: An empirical investigation', **Journal of Financial and Quantitative Analysis**, pp. 541-565.

Clayman, M (1987). 'In search of excellence: The investors viewpoint', **Financial Analyst Journal**, May-June, pp. 54-63.

Coats, P. K. and L. F. Fant (1993). 'Recognising financial distress patterns using a neural network tool', **Financial Management**, Autumn, pp. 142-153.

Collins, D., S. P. Kothari and J Rayburn (1987). Firm size and the information content of prices with respect to earnings, **Journal of Accounting and Economics**, 9, pp. 111-138.

Conrad, J. and G. Kaul (1993). 'Long term overreaction or biases in computed returns?', **Journal of Finance**, March, pp. 39-63.

Conyon, M.. J. and P. Clegg (1994). 'Pay at the top: a study of the sensitivity of top director remuneration to company specific shocks', **National Institute of Economic Review**, August.

Cooney, J. W. and A. Kalay (1993). 'Positive information from equity issue announcements', **Journal of Financial Economics**, 33, pp. 149-172.

Coughlan, A. T. and R. M. Schmidt (1985). 'Executive compensation, management turnover, and firm performance: An empirical investigation', *Journal of Accounting and Economics*, 7, pp. 43-66.

DeAngelo, H. and L. DeAngelo (1990). 'Dividend policy and financial distress: An empirical investigation of troubled NYSE firms', *Journal of Finance*, 45, pp 1425-1431.

DeAngelo, H., L. DeAngelo and D. Skinner (1992). 'Dividend and Losses', *Journal of Finance*, Vol 57/5, December, pp 1837-1863.

De Bondt, W. F. M. and R. H. Thaler (1985). 'Does the stock market overreact?', *Journal of Finance*, July, 40, pp. 793-805.

De Bondt, W. F. M. and R. H. Thaler (1987). 'Further evidence of investor overreaction and stock market seasonality', *Journal of Finance*, July, 42, pp. 557-581.

De Bondt, W. F. M. and R. H. Thaler (1990). 'Stock market volatility: Do security analysts overreact?', *American Economic Review*, Proceedings Papers, pp. 52-57.

de Carmoy, H. (1990). 'Global banking strategy: Financial markets and industrial decay', Basil Blackwell.

Demsetz, H. and K. Lehn (1985). 'The structure of corporate ownership: Causes and consequences', *Journal of Political Economy*, pp.1155-1177.

Denis, D. J., D. K. Denis and A. Sarin (1994). 'The information content of dividend changes: Cash flow signalling, overinvestment and dividend clienteles', *Journal of Financial and Quantitative Analysis*, Vol 29. No 4, December, pp.

Diamond, D (1993). 'Seniority and maturity of debt contracts', *Journal of Financial Economics*, 33, pp. 341-368.

Dimson, E (1979). 'Risk measurement when shares are subject to infrequent trading', *Journal of Financial Economics*, 1979, 7, pp. 197-226.

Duhaime, I. M. and Grant, J. H (1984). 'Factors influencing divestment decision-making: Evidence from a field study', *Strategic Management Journal*, 5, pp. 301-318.

Dyl, E. And K. Maxfield (1987). 'Does the stock market overreact?' Additional Evidence,' Working Paper, University of Arizona.

Eckbo, B. E. (1986). 'Valuation effects of corporate debt offerings', **Journal of Financial Economics**, 15, pp. 119-151.

Eisenhardt, K. M (1989). 'Agency theory: An assessment and review', **Academy of Management Review**, Vol. 14, No.1, pp. 57-74.

Ettredge, M. and R. J. Fuller (1991). 'The negative earnings effect', **The Journal of Portfolio Management**, Spring, pp. 27-33.

Fadel, H. and J. M. Parkinson (1978). 'Liquidity evaluation by means of ratio analysis', **Accounting and Business Research**, 8, no 30, pp. 101-107.

Fama, E (1970). 'Efficient capital markets: A review of theory and empirical work', **Journal of Finance**, XXV, No 2, pp. 383-417.

Fama, E (1991). 'Efficient capital markets: II', **Journal of Finance**, 46, pp. 1575-1617.

Fama, E. F., and M. C. Jensen (1983). 'Separation of ownership and control', **Journal of Law and Economics**, 26, pp. 301-325.

Finkin, E. F. (1985). 'Company turnaround', **Journal of Business Strategy**, 5/4, pp. 14-24.

Fowler, D. J. and C. H. Rourke (1983). 'Risk measurement when shares are subject to infrequent trading: Comment', **Journal of Financial Economics**, 12, pp. 279-283.

Franks, J. R. and W. N. Tourous (1989). 'An empirical investigations of US firms in reorganisation', **Journal of Finance**, Vol XLIV, No 3, July.

Franks, J. R. and W. N. Tourous (1994). 'A comparison of financial recontracting in distressed exchanges and Chapter 11 reorganisations', **Journal of Financial Economics**, 35, pp 349-370.

Freeman, S. J. And K. S. Cameron (1993). 'Organisational downsizing: A convergence and reorientation framework', **Organization Science**, Vol 4, 1, pp. 10-29.

Frydman, H., E. I. Altman and D. Kao (1985). 'Introducing recursive partitioning for financial classification : The case for financial distress', **Journal of Finance**, March, pp 269-291.

- Gahlon, J. M. and R. L. Vigeland (1988). 'Early warning signs of bankruptcy using cash flow analysis', **Journal of Commercial Bank Lending**, December, pp.4-15.
- Gambling, T. (1985). 'The accountants 's guide to the galaxy including the profession at the end of the universe', **Accounting, Organisations and Society**, Vol 10, No. 4, pp. 289-307.
- Gentry, J. A., P. Newbold and D. T. Whitford (1985). 'Classifying bankrupt firms with fund flow components', **Journal of Accounting Research**, Spring, pp. 146-160.
- Gertner, R., and D. Scharfstein (1991). 'A theory of workouts and the effects of reorganization law', **The Journal of Finance**, Vol XLVI no 4, September, pp. 1189-1222.
- Gilson, S. C. (1989). 'Management turnover and financial distress', **Journal of Financial Economics**, 25, pp 241-262.
- Gilson, S. C. (1990a). 'Bankruptcy, boards, banks, and bondholders - Evidence on changes in corporate ownership and control when firms default', **Journal of Financial Economics**, 27, pp 355-387.
- Gilson, S. C., and K. John and L. H. P. Lang (1990b). 'Troubled debt restructuring: An empirical study of private reorganisation of firms in default', **Journal of Financial Economics**, 27, pg 315-353.
- Gilson, S. C. and M. R. Vetsuypens (1993). 'CEO compensation in financially distressed firms: An empirical analysis', **Journal of Finance**, Vol 58/2, June, pp 425-457.
- Graham, K. R. and M. D. Richards (1979). 'Relative performance deterioration, management and strategic change in rail-based holding companies', **Proceedings of the 39th Annual Academy of Management**, Atlanta, Georgia.
- Grinyer, P. H., D. G. Mayers, and P. Mckiernan (1988). 'Sharpbenders: The secrets of unleashing corporate potential', Oxford, Basil Blackwell.
- Grinyer, P. and P. Mckiernan (1990). 'Generating major change in stagnating companies', **Strategic Management Journal**, Vol 11, pp. 131-146.
- Hambrick, D. C. and S. M. Schecter (1983). 'Turnaround strategies for mature industrial-product business units', **Academy of Management Journal**, Vol 23, No 2, pp. 231-248.

Hambrick, D. C. and R. A. D'Aveni (1988). 'Large corporate failures as downward spirals', **Administrative Science Quarterly**, 33, pp, 1-23.

Hamermesh, R. G. (1977), 'Responding to divisional profit crisis, **Harvard Business Review**, 55,2 , Mar-April 1977, pp. 124-130.

O'Hanlon, J. and R. Whiddett (1991). 'Do UK security analysts over-react?', **Accounting and Business Research**, Vol 22, No 85, pp. 63-74 .

Hausman, J. A. (1978). 'Specification tests in econometrics', **Econometrica**, 46, pp. 1251-1272.

Healy P. M. and K. G. Palepu (1988). 'Earnings information conveyed by dividend initiations and omissions', **Journal of Financial Economics**, 21, pp. 149-175.

Hearth, D. and J. K. Zaima (1984). 'Divestiture uncertainty and shareholder wealth: Evidence from the USA (1975-82)', **Journal of Business Finance and Accounting**, 13, pp. 71-85.

Hermalin, B and M. Weisbach (1988). 'The determinants of board composition', **Rand Journal of Economics**, 19, pp. 589-606.

Hermalin, B. and M. Weisbach (1992). 'The effects of board composition and direct incentives on firm performance', **Financial Management**, 20, pp. 101-112.

Hill, C W L and S. A. Snell (1989). 'Effects of ownership structure on corporate productivity', **Academy of Management Journal**, 32, pp. 25-46.

Hirschey, M., M. B. Slovin and J..K. Zaima (1990). 'Bank debt, insider trading and the return to corporate sell-offs', **Journal of Banking and Finance**, 14, pp 85-98.

Hite, G. L. and J. E. Owers(1983). 'Security price reactions around corporate spin-off announcements', **Journal of Financial Economics**, 12, pp 409-436.

Hite, G. L., J. E. Owers and R. C. Rogers. 'The market for inter-firm asset sales, partial sell-offs and total liquidations', **Journal of Financial Economics**, 18, pp. 229-252.

Hofer, C. W. (1980). 'Turnaround strategies', **Journal of Business Strategy**, 1,1 Summer, pp. 19-31

Hoffman, R. C. (1989). 'Strategies for corporate turnarounds: what do we know about them?', **Journal of General Management**, 46, pp 46-66.

Holderness, C. G. and D. P. Sheehan (1985). 'Raiders or saviours?: The evidence on six controversial investors', **Journal of Financial Economics**, 14, pp. 555-579.

Holderness, C. G. and D. P. Sheehan (1988). 'The role of majority shareholders in publicly held corporations: An exploratory analysis', **Journal of Financial Economics**, 20, pp 317-346.

Howe, J. S (1986). 'Evidence on stock market overreaction', **Financial Analysts Journal**, July-August, pp. 74-77.

Jacobs, B. I. And K. N. Levy (1989). 'The complexity of the stock market', **The Journal of Portfolio Management**, Fall, pp. 7-27.

James. C (1987). 'Some evidence of the uniqueness of bank loans', **Journal of Financial Economics**, 19, pp. 217-235.

Jarrell, G. and A. B. Poulsen (1990). 'Shark repellents and stock prices: The effects of antitakeover amendments since 1980', **Journal of Financial Economics**, Vol 18, pp. 127-68.

Jensen, M. C. and W. Meckling (1976). 'Theory of the firm: Managerial behaviour, agency costs, and ownership structure', **Journal of Financial Economics**, 3, pp. 306-360.

Jensen, M (1986). 'Agency costs of free cash flow, corporate finance and takeovers', **American Economic Review**, 76, pp 323-329.

Jensen, M. C. and J. B. Warner (1988). 'The distribution of power among corporate managers, shareholders and directors', **Journal of Financial Economics**, 20, pp 3-24.

Jensen, M (1989a). 'Active investors, LBO's and privatisation of bankruptcy', **Journal of Applied Corporate Finance**, 2, pp 35-44.

Jensen, M (1989b). 'Eclipse of the public corporation', **Harvard Business Review**, Sep/Oct, pp. 61-74.

Jensen. G. R. and J. M. Johnson (1995). 'The dynamics of corporate dividend reductions', **Financial Management**, Vol. 24 No. 4, Winter 1995, pp. 31-51.

- John, K., L. H. P. Lang and J. Netter (1992). 'The voluntary restructuring of large firms in response to performance decline', *Journal of Finance*, July, pp. 891-917.
- Johnson, R. A., R. E. Hoskisson and M. A. Hitt (1993). 'Board of director involvement in restructuring: The effects of board versus managerial controls and characteristics', *Strategic Management Journal*, 14, pp 33-50.
- John, K (1993). 'Managing financial distress and valuing distressed securities: a survey and research agenda', *Financial Management*, Autumn, pp 60-77.
- John, K., L. H. P. Lang and J. Netter (1992). 'The voluntary restructuring of large firms in response to performance decline', *Journal of Finance*, July, pp. 891-917.
- Jones, C. J., D. P. Tweedie and G. Whittington (1976). 'The regression portfolio: A Statistical investigation of relative decline portfolio', *Journal of Business Finance and Accounting*, Summer, pp. 71-92.
- Kahneman, D. and A. Tversky (1973). 'On the psychology of prediction', *Psychological Review*', 80, pp. 237-251
- Kalay A. and U Lowenstein (1985). 'Predictable events and excess returns: The case of dividend announcements', *Journal of Financial Economics*, 14, pp. 422-449.
- Keasey, K. and R. Watson (1987). 'Non-financial symptoms and the prediction of small company failure: A test of Argenti's hypotheses', *Journal of Business Finance and Accounting*, 14(3), Autumn, pp 335-353.
- Keim, D. B. and R. F. Stambaugh (1986). 'Predicting returns in the stock and bond markets', *Journal of Financial Economics*, 17, pp. 357-390.
- Kent, P (1994). ' The London Approach: Lessons from recent years', *The Treasurer*, March, pp 5-9.
- Kent, P (1994). ' The London Approach: Distressed debt trading', *Bank of England Quarterly Bulletin*, May, pp. 172-174.
- Khanna, V. and A. B. Poulsen (1995). 'Managers of financially distressed firms: villains or scapegoats?', *Journal of Finance*, December, pp. 919-940.
- Kharbanda, O. P. and E. A. Stallworthy (1985). 'Corporate failure', Heinemann, London.

- Kharbanda, O. P. and E. A. Stallworthy (1987). 'Company rescue: How to manage a company turnaround', Heinemann, London.
- Kothari, S. P (1992). 'Price-earnings regressions in the presence of prices leading earnings', *Journal of Accounting and Economics*, 15, pp. 173-202.
- Kothari, S. P. and R. G. Sloan (1992). 'Information in prices about future earnings', *Journal of Accounting and Economics*, 15, pp 143-171.
- Klein, A (1990). 'A direct test of the cognitive bias theory of share price reversals', *Journal of Accounting and Economics*, 13, pp. 155-166.
- Lang, L. H. P. and R. H. Litzenger (1989). 'Dividend announcements: Cash flow signalling vs. free cash flow hypothesis?', *Journal of Financial Economics*, 24, pp. 181-191.
- Lang, L. and R. Stulz (1992). 'Contagion and competitive intra-industry effects of bankruptcy announcements', *Journal of Financial Economics*, 32, pp. 45-60.
- Lang, L., A. Poulsen and R. Stulz (1995). 'Asset sales, firm performance, and the agency costs of managerial discretion', *Journal of Financial Economics*, 37, pp. 3-37.
- Lasfer, M. A., P. S. Sudarsanam and R. J. Taffler (1996). 'Financial distress, asset sales and lender monitoring', *Financial Management*, Autumn.
- Lau, A H (1987). 'A five state financial distress model', *Journal of Accounting Research*, Vol 25, 1, pp. 127-138.
- Levis, M. (1995). 'Seasoned equity offerings and the short and long-run performance of initial public offerings', *European Financial Management*.
- Lehmann, B. N (1990). ' Fads, martingales and market efficiency', *Quarterly Journal of Economics*, 105, pp. 1-28.
- Liebeskind, J., M. Wiersema and G. Hansen (1992). 'LBOs, corporate restructuring, and incentive-intensity hypothesis', *Financial Management*, Spring, pp 73-88.
- MacDonald, R. and D. M. Power (1991), 'Persistence in UK stock market returns: Aggregated and disaggregated perspectives', in M Taylor (ed.) *Money and Financial Markets*, Blackwell, Oxford, pp. 277-296.

MacDonald, R. and Power, D (1992), 'Persistence in UK stock market returns: Some evidence using high-frequency data', **Journal of Business Finance and Accounting**, 19, pp. 505-14.

MacDonald, R. and D. M. Power (1993), 'Persistence in UK market returns: A disaggregated perspective', **Applied Financial Economics**, March, pp. 27-38.

Makridakis, S. (1991). 'What can we learn from corporate failure', **Long Range Planning**, Vol 24, no 4, pp. 115-126.

Mallette, P. and K. L. Fowler (1992). 'Effects of board composition and stock ownership on the adoption of 'poison pills'', **Academy of Management Journal**, 35/5, pp. 1010-1035.

Marris, R (1964). 'The economic theory of managerial capitalism' Free Press, Glencoe, IL.

Marsh, P (1982). 'The choice between equity and debt: An empirical study', **Journal of Finance**, Vol 37/1, March, pp. 121-144.

Marsh, P (1992). 'Dividend announcements and stock price performance', London Business School.

Masulis, R. and A. Korwar (1986). 'Seasoned equity offerings: An empirical investigation', **Journal of Financial Economics**, 15, pp. 31-60.

McConnell, J. J. and H. Servaes (1990). 'Additional evidence on equity ownership and corporate value', **Journal of Financial Economics**, 27, pp 595-612.

Meeks, G., and G. Whittington (1975). 'Director's pay, growth and profitability', **Journal of Industrial Economics**, 24, 1, pp. 1-14.

Melin, L (1985). 'Strategies in managing turnaround', **Long Range Planning**, 18, 1, pp. 80-86.

Mikkelson, W. H. and M. M. Partch (1986). 'Valuation effects of security offerings and the issuance process', **Journal of Financial Economics**, 15, pp. 31-60.

Mikkleson, W. H. and R. S. Ruback (1985). 'An empirical analysis of the interfirm equity investment process', **Journal of Financial Economics**, 14, pp. 523-553.

Miller M and F Modigliani (1961). 'Dividend policy, growth and the valuation of shares', **Journal of Business**, 4, pp. 411-433.

Miller, M. H. And K. Rock (1985). 'Dividend policy under asymmetric information', **Journal of Finance**, 40, pp. 1031-1051.

Modigliani F and M Miller (1964). 'The cost of capital, corporation finance and the theory of investment: A reply', **American Economic Review**, 44, pp.656-682.

Mueller, D. C. (1977). 'The persistence of profits above the norm', **Economica**, November, pp. 369-380.

Murphy, K. J. and J. L. Zimmerman (1993). 'Financial performance surrounding CEO turnover', **Journal of Accounting and Economics**, 16, pp. 273-315.

Muth, J (1961). 'Rational expectations and the theory of price movements', **Econometrica**, July, pp. 315-335.

Myers, S. C (1977). 'Determinants of corporate borrowing', **Journal of Financial Economics**, November, pp 147-176.

Nelson, R. and D. Clutterbuck (1988). 'Turnaround', Mercury Book.

Ofek, E. (1993). 'Capital structure and firm response to poor performance : An empirical analysis', **Journal of Financial Economics**, 34, pp 3-30.

O'Neill, H. M (1981). 'Turnaround strategies in the commercial banking industry', UMI Research Press.

O'Neill, H. M. (1986). 'Turnaround and recovery: What strategy do you need?', **Long Range Planning**, Vol 19, No 1, pp. 80-88.

Pant, L W (1986). 'The determinants of corporate turnaround', doctoral dissertation, Boston University.

Pant, L. W (1987). 'Fuelling corporate turnaround through sales growth', **Journal of Commercial Bank Lending**, December, pp. 25-32.

Pearce II, J. A. and K. Robbins (1993). 'Toward improved theory and research on business turnaround', **Journal of Management**, Vol 19, No 3, pp. 613-636.

Pearce II, J. A. and K. Robbins (1994). 'Retrenchment remains the foundation of business turnaround', **Strategic Management Journal**, 15, pp. 407-417.

- Pettengill, G. N. and B. D. Jordan (1990). 'The overreaction hypothesis, firm size, and stock market seasonality', *The Journal of Portfolio Management* Spring, pp. 61-64.
- Poterba, J. M. and L. H. Summers (1988). 'Mean reversion in stock prices: evidence and implications', *Journal of Financial Economics*, 22, pp. 27-59.
- Pound, J (1988). 'Proxy contests and the efficiency of shareholder oversight', *Journal of Financial Economics*, 20, pp. 237-265.
- Power, D. M. and A. A. Lonie (1993). 'The overreaction effect: Anomaly of the 1980s?', *British Accounting Review*, 25, pp. 325-366.
- Power, D. M., A. A. Lonie and R. Lonie (1991). 'The overreaction effect - some UK evidence', *British Accounting Review*, June, pp. 149-170.
- Rajan, R (1992). 'Insiders and outsiders: The choice between informed and arm's-length debt', *Journal of Finance*, 47, pp. 1367-1400.
- Ramanujam, V (1984). 'Environmental context, organisational context, strategy, and corporate turnaround'. PHD Dissertation, University of Pittsburgh.
- Rechner, P. L. and D. R. Dalton (1989). 'The impact of CEO as board chairperson on corporate performance: Evidence vs. rhetoric', *Academy of Management Executive*, 3, pp. 141-143.
- Rechner, P. L. and D. R. Dalton (1991). 'CEO duality and organisational performance: A longitudinal analysis', *Strategic Management Journal*, Vol 12, pp 155-160.
- Robbins, D. K. and J. A. Pearce II (1992). 'Turnaround: Retrenchment and recovery', *Strategic Management Journal*, Vol 13, pp. 287-309.
- Robbins, D. K. and J. A. Pearce II (1993). 'Entrepreneurial retrenchment among small manufacturing firms', *Journal of Business Venturing*, 8, pp. 301-318.
- Rock, K (1986). 'Why new issues are underpriced', *Journal of Financial Economics*, 15, pp. 187-212.
- Rosenstein, S. and J. H. Wyatt (1990). 'Outside directors, board independence, and shareholder wealth', *Journal of Financial Economics*, 26, pp. 175-191.

Schendel, D., G. R. Patton (1976). 'Corporate stagnation and turnaround', **Journal of Economics and Business**, 28, 3, Spring-Summer, pp. 236-241.

Schendel, D., G. R. Patton and J. Riggs (1976). 'Corporate turnaround strategies: a study of profit decline and recovery', **Journal of General Management**, Spring, pp. 3-11.

Schipper, K. and A. Smith (1983). 'Effects of recontracting on shareholders wealth: The case of voluntary spin-offs', **Journal of Financial Economics**, 12, pp 437-467.

Schipper, K. and A. Smith (1986). 'A comparison of equity carve-outs and seasoned equity offerings: Share price effects and corporate restructuring', **Journal of Financial Economics**, 15, pp 153-186.

Schleifer, A. and R. W. Vishny (1984). 'Large shareholders and corporate control', **Journal of Political Economy**, 94, pp. 461-488.

Schleifer, A. and R. W. Vishny (1989). 'Management entrenchment: The case of manager-specific investments', **Journal of Financial Economics**, 25, pp. 123-139.

Schleifer, A. and R. W. Vishny (1992). 'Liquidation values and debt capacity: A market equilibrium approach', **Journal of Finance**, 47, pp. 1343-1366.

Scholes, M. and J. Williams (1977). 'Estimating beta from nonsynchronous data', **Journal of Financial Economics**, 5, pp. 309-327.

Scott, J (1981). 'The probability of bankruptcy : A comparison of empirical predictions and theoretical models', **Journal of Banking and Finance**, September, pp 317-344.

Seth, A. and J. Easterwood (1993). 'Strategic redirection in large management buyouts: The evidence from post-buyout restructuring activity', **Strategic Management Journal**, Vol 14, pp 251-273.

Shapiro, A. C (1991). 'Modern corporate finance', Macmillans, New York.

Shivdasani, A (1993). 'Board composition, ownership structure, and hostile takeovers', **Journal of Accounting and Economics**, 16, pp. 167-198.

Slatter, S. (1984). 'Corporate recovery: Successful turnaround strategies and their implementation', Penguin.

- Sloma, R. S (1985). **'The turnaround manager's handbook'**, The Free Press, New York.
- Smith, Jr. C. W. (1986). **'Investment banking and the capital acquisition process'**, **Journal of Financial Economics**, 15, pp. 3-29.
- Stallworthy, E. A. and O. P. Kharbanda (1988). **'Takeovers, acquisitions and mergers: Strategies for rescuing companies in distress'**, Heinemann, London.
- Stopford, J. M. and C. Baden-fuller (1990). **'Corporate rejuvenation'**, **Journal of Management Studies**, 27, pp. 399-415.
- Storey et al, (1987) in Keasey and Watson, **Journal of Banking and Finance**, 14/3, Autumn 1987, pp 335-350.
- Sudarsanam, S (1995a). **'Essence of mergers and acquisitions'**, Prentice Hall.
- Sudarsanam, S (1995b). **'Large shareholders and corporate restructuring'**, Paper presented at the Financial Management Association Meeting, New York, October 1995.
- Sudarsanam, S (1996). **'Large shareholders, takeovers and target valuation'**, **Journal of Business Finance and Accounting**, March.
- Taffler, R. J (1976). **'Finding those firms in danger'**, **Accountancy Age**, 16 July.
- Taffler, R. J. and H. Tisshaw (1977). **'Going, going, gone - four factors which predict'**, **Accountancy**, March, pp. 50-53.
- Taffler, R. J (1983). **'The assessment of company solvency and performance using a statistical model'**, **Accounting and Business Research**, 52, pp. 295-307.
- Taffler, R. J (1984). **'Empirical models for the monitoring of UK corporations'**, **Journal of Banking and Finance**, 8, pp. 199-227.
- Taffler, R. J (1995). **'The use of the z-score approach in practice'**, City University Business School, Centre for Empirical Research in Finance and Accounting, Working Paper 95/1.
- Taylor, B (1992). **'Turnaround, recovery and growth: The way through the crisis'**, **Journal of General Management**, Vol. 18, No. 2, pp. 5-13.

- Thompson, S., m. Wright and K Robbie (1989). Buy-outs, debt and efficiency', **Journal of Applied Corporate Finance**, 2,1, pp. 76-85.
- Warner, J (1977). 'Bankruptcy costs: Some evidence', **Journal of Finance**, Vol XXXII, No. 2, May, pp. 71-83.
- Warner, J. B., R. S. Watts and K. H. Wruck (1988). 'Stock prices and top management changes', **Journal of Financial Economics**, 20, pp. 461-492.
- Weisbach, M (1988). 'Outside directors and CEO turnover', **Journal of Financial Economics**, 20, pp. 431-460.
- Weitzel, W. And E. Jonsson (1989). 'Decline in organisations: A literature integration and extension', **Administrative Science Quarterly**, 34, pp. 91-109.
- Weisbach, M (1988). 'Outside directors and CEO turnover', **Journal of Financial Economics**, 20, pp 431-460.
- Whittington, W. (1991). 'Recession strategies and top management change', **Journal of General Management**, Vol. 16, no. 3, Spring, pp. 11-27.
- Winn, J (1993). 'Performance measures for corporate decline and turnaround', **Journal of General Management**, Vol 19 No 2, Winter.
- Worrell, D. L., W. N. Davidson III, and J. L. Glascock (1993). 'Stockholder reactions to departures and appointments of key executives attributable to firings', **Academy of Management Journal**, Vol. 36, No.2 , pp. 387-401.
- Wright, M. and Coyne, J. (1985). 'Management buyouts in British industry', **Croom-Helm**.
- Wright, M. and S. Thompson (1987). 'Divestment and the control of divisionalised firms', **Accounting and Business Research**, Vol. 17, no. 67, pp. 259-267.
- Wruck, K. H. (1989). 'Equity ownership concentration and firm value: Evidence from private equity financing', **Journal of Financial Economics**, 23, pp. 3-28.
- Wruck, K. H. (1990). 'Financial distress, reorganisation, and organisational efficiency', **Journal of Financial Economics**, 27, pp. 419-444.
- Zarowin, P (1989). 'Does stock market overreact to corporate earnings information?', **Journal of Finance**, 5, December, pp. 1385-1399.

Zarowin, P (1990). 'Size, seasonality and stock market overreaction', **Journal of Financial and Quantitative Analysis**, pp. 113-125.

Zimmerman, F. M (1989). 'Managing a successful turnaround', **Long Range Planning**, Vol 22. No.3, pp 105-124.