Corporate Finance – Semester 2

**SHARE VALUATIONS AND CORPORATE RESTRUCTURING**

We shall take up following topics in this hand out:

Assets Based Share Valuations

Hybrid Valuation methods

Procedure for public takeover

Procedure for private takeover

Anti-takeover tools

Poison pill Pac man

White knight Counter offer

Disposal of key assets Acquisition by the target Shark repellent

Political pressure

**Assets Based Share Valuations**

Asset-based methods typically involve restating both assets and liabilities to their current values to arrive at a net asset value. The restatement can be done on an individual component level (discrete valuation) or collectively (collective valuation). Given the relative difficulty of individually valuing a variety of assets, such as real estate, machinery and equipment, and inventory, it is often necessary to employ valuation specialists. Collective valuation requires a single analysis, which identifies the collective value of the assets and liabilities over and above their recorded value (i.e., a price-to-book multiple). Even with asset-based models, value remains a function of expected benefits to the owners. The value of assets is generally derived from either future income-generating potential or liquidation value, depending on the circumstances at a given time.

Some add a fourth approach to valuation to the three that we describe in this handout. They argue that you can argue the individual assets owned by a firm and use that to estimate its value – asset based valuation models. In fact, there are several variants on asset based valuation models. The first is liquidation value, which is obtained by aggregating the estimated sale proceeds of the assets owned by a firm. The second is replacement cost, where you evaluate what it would cost you to replace all of the assets that a firm has today.

While analysts may use asset-based valuation approaches to estimate value, we do not consider them alternatives to discounted cash flow, relative or option pricing models since both replacement and liquidation values have to be obtained using one or more of these approaches. Ultimately, all valuation models attempt to value assets – the differences arise in how we identify the assets and how we attach value to each asset. In liquidation valuation, we look only at assets in place and estimate their value based upon what similar assets are priced at in the market. In traditional discounted cash flow valuation, we consider all assets including expected growth potential to arrive at value.

The two approaches may, in fact, yield the same values if you have a firm that has no growth assets and the market assessments of value reflect expected cash flows.

Asset based methods are generally considered suitable when shareholdings > 50% are being valued. Such shareholdings give the holder the right to control the acquisition and disposal of the underlying assets. Therefore, if there are assets not needed for generation of income, the controlling shareholders may cause these to be realized to generate cash.

Book Values: these figures are bases on past or historical costs and are meaningless and useless to be used for merger transaction valuations.

Replacement Cost: this should provide a measure of the maximum amount that any buyer should pay for the whole business, since it represents the total cost of forming the business from scratch. However, a major element of any business as a going concern is likely to be the goodwill. Since this can only be defined as income based value of business – tangible assets it may be seen that there is no real way of applying a pure asset based value to a business. It is always necessary to consider an income-based value as well.

Break up value: is the assets in the business will often be less than any other computed value. It represents the minimum price, which should be accepted for the sale of a business as a going concern, since if the income based valuations give figures lower than the break up value it is apparent that the owner would be better off by ceasing to trade and selling off all the assets piecemeal.

However, when a break up is considered in this way it must be remembered to include such items as redundancy costs, liquidator’s which may have substantial effect on the final outcome.

**Hybrid Methods – Mix Of Asset Based & Income Method:**

The income and asset-based approaches to valuation have relative strengths as well as obvious limitations. For example, the income approach allows for specific and direct estimation of future benefits to the owners, which is consistent with the theory of value. On the other hand, if the estimation of future benefits is directly based on historical income, the precision of the estimate will depend heavily on the persistence embodied in the historical income measure and on the growth assumptions incorporated into the model. If, for example, current or historical income contains large transitory components, the relationship between historical and future income may be distorted. In addition, to the extent an inappropriate discount rate is utilized, value estimates will be adversely affected.

Asset-based valuation approaches can be effective in that the accurate identification of individual asset and liability values will yield a reliable value estimate. In addition, unlike the income approach, an equity discount rate, the estimation of which can have a significant impact on the valuation conclusion, is not required for an asset-based approach. On the other hand, it is often difficult to accurately restate book value to current value for an array of assets, especially when a significant amount of unrecorded intangible assets exists.

This method includes the characteristics of both income and asset based valuation methods. For example, the income approach allows for specific and direct estimation of future benefits to the owners, which is consistent with the theory of value.

The estimation of future benefits is directly based on historical income; the precision of the estimate will depend heavily on the persistence embodied in the historical income measure and on the growth assumptions incorporated into the model asset-based valuation approaches can be effective in that the accurate identification of individual asset and liability values will yield a reliable value estimate. in addition, unlike the income approach, an equity discount rate, the estimation of which can have a significant impact on the valuation conclusion, is not required for an asset-based approach.

Taken collectively, however, income and asset-based valuations generally yield better valuation accuracy and more-effective analysis, which is the real benefit of a hybrid approach.

**Acquisition Procedures:**

* Procedure for public take over:
* Growth / expansion is decided
* Predator company appoints experts – legal consultants, banks, accountants and stock brokers
* Decision regarding contact with target firm – approach before the bid or hostile takeover
* Purchase of certain % age of shares of target
* Establish an offer and communicate target

Includes offer document, offer validity, predator may revise offer if declined by target

* Acquisition of private company:
* Limited consultancy services from expert are required. internal evaluation is normally enough.
* Detailed investigation is conducted before the transaction.
* Offer price is negotiated by both parties
* Finalization of deal by entering into a contract
* Payment of price finishes the deal.

**Anti-takeover tools:**

Takeovers are not easy – there is always some opposition to takeovers by some or all of the stakeholders of target company. In this section, you will learn how to thwart a takeover attempt successfully. The following methods have been used in practical life to stop a takeover:

**Poison pill:**

Poison pill originally meant a *literal* poison pill (often a glass vial of cyanide salts) carried by various spies throughout history, and by Nazi leaders in WWII Spies could take such pills when discovered, eliminating any possibility that they could be interrogated for the enemy's gain. It has since become a term referring to any strategy, generally in business or politics, to increase the likelihood of negative results over positive ones for anyone who attempts any kind of takeover.

**Pac-Man:**

The **Pac-Man defense** is a defensive option to stave off a hostile takeover. It is when a company that is under a hostile takeover acquires its would-be buyer.

The most quoted example in U.S. corporate history is the attempted hostile takeover of Martin Marietta by Bendix Corporation in 1982. In response, Martin Marietta started buying Bendix stock with the aim of assuming control over the company.

Bendix persuaded Allied Corporation to act as a "white knight," and the company was sold to Allied the same year. The incident was labeled a "Pac-Man defense" in retrospect. The name refers to when Pac-Man, the star of the videogame of the same name, turns around and devours the ghost that was previously pursuing him (after eating a Power Pill that allows him to do so). The term (though not the technique) was coined by buyout guru Bruce Wasserstein.

**White knight (business)**

In business, a **white knight** may be a corporation, a private company, or a person that intends to help another firm. There are many types of white knights.

The first type refers to the friendly acquirer of a target firm in a hostile takeover attempt by another firm. The intention of the acquisition is to circumvent the takeover of the object of interest by a third, unfriendly entity, which is perceived to be less favorable. The knight might defeat the undesirable entity by offering a higher and more enticing bid, or strike a favorable deal with the management of the object of acquisition. In short, if Company T (target) is going to be acquired by Company H (hostile firm), but Company A (acquirer) can acquire ownership of Company T, and then Company A would be acting as the white knight. The second type refers to the acquirer of a struggling firm that may not necessarily be under threat by a hostile firm. The financial standing of the struggling firm could prevent any other entity being interested in an acquisition. The firm may already have huge debts to pay to its creditors, or worse, may already be bankrupt. In such a case, the knight, under huge risk, acquires the firm that is in crisis. After acquisition, the knight then rebuilds the firm, or integrates it into itself

**Disposal of Key Assets:**

Disposal of key assets is also very important tools which go in anti, because some times vital assets when go to liquidate or companies go to amalgamate then, too many hurdles come in order to process the disclosure of the assets, because investment made by the investor.

**Acquisition by the Target:**

A **targeted repurchase** is a technique used to thwart a hostile takeover in which the target firm purchases back its own stock from an unfriendly bidder, usually at a price well above market value.

**Politics**

Political pressure is an effective anti-take over tool. Two good examples will make you understand better how a government can stop takeover bid.

DWP – Middle East based port company acquired the management of some US ports after successful bidding. Later, as the congress raised concern about the security of its ports, US president had to interfere to stop this bid. On the same lines, an Indian business tycoon had a successful bidding of a French steel manufacturer but later French government intervened and cancelled the bid.

A poison pill may also be used in politics such as attaching an amendment so distasteful to a bill that even the bill's supporters are forced to vote against it. This manipulative tactic may be intended to simply kill the bill, or to create a no-win situation for the bill's supporters, so that the bill's opponents can accuse them of voting for something bad no matter what. This is sometimes known as a "wrecking amendment".

**CORPORATE RESTRUCTURING**

This handout will take care of following topics:

Corporate Restructuring

Divestment

Purpose of divestment

Buyouts

Types of buyouts

Financial distress – introduction

**Corporate Restructuring**

Corporate restructuring and improved corporate governance are essential parts of economic reform programs under way in many countries. How can corporations be restructured to promote growth and reduce excessive debt without placing undue burdens on taxpayers? What framework is needed to promote better corporate governance?

CORPORATE Restructuring involves restructuring the assets and liabilities of corporations, including their debt-to-equity structures, in line with their cash flow needs to promote efficiency, restore growth, and minimize the cost to taxpayers. Corporate governance refers to the framework of rules and regulations that enable the stakeholders to exercise appropriate oversight of a company to maximize its value and to obtain a return on their holdings. Both corporate and financial sector restructuring are central to ongoing reform programs in East Asia. This article focuses on reform efforts in Indonesia and Korea, as well as Malaysia and Thailand.

Corporations, government, and banks have close relationships in many East Asian countries. Conglomerates controlled by a small group, nontransparent accounting, interlocking ownership between the corporate and financial sectors, and weak minority shareholder rights dominate many sectors of their economies. It is estimated that the top 10 families in Indonesia in 1997 controlled corporations worth more than half the country's market capitalization. Comparable figures are one- half in Thailand, one-fourth in Korea and Malaysia, but only 2–3 percent in Japan. Fundamental cultural and institutional changes are required if a new corporate governance structure is to be established with arm's-length, transparent relations between corporations, government, and banks. Changing corporate governance, however, is a long-term process. In East Asia, the immediate task is to deal with the present crisis by undertaking integrated restructuring of the assets and liabilities of highly indebted firms, external debt restructuring, and financial sector reform. Integrated restructuring of both corporate assets and liabilities is required if competitive enterprise and financial sectors are to be developed, the risk of crises recurring is to be reduced, and the cost to taxpayers of accomplishing these goals is to be minimized.

Buildup of lnerabilities in the corporate sector. Before the crisis hit, many East Asian corporations expanded into sprawling conglomerates making extensive use of debt, because equity markets were undeveloped and, in many cases, owners preferred to retain control of firms with concentrated holdings. There were also structural weaknesses in these countries' banking supervision systems and internal bank management. Much of the debt owed to banks and corporations was unheeded and short term, which led to extreme over indebtedness following the devaluations and high interest rates of 1997 and 1998. Two factors that make financial crises in East Asia difficult to manage are the large, short-term internal and external debts and openness of many East Asian economies, both of which constrain their monetary and exchange rate policies.

Need for a comprehensive approach. Resolving corporate sector, financial sector, and external debt problems requires a comprehensive and integrated approach. Since good firms are necessary if an economy is to have good banks, corporate restructuring must be linked to bank restructuring, which, in turn, must be linked to the settlement of external debt problems. Perverse incentives and inequitable burden sharing can result if obligations to short-term external creditors are met and losses are concentrated on the government, labor, and, ultimately, the taxpayers. The costs to the government of bank recapitalization are high—we estimate that they range between 15 and 35 percent of GDP for the four countries discussed in this article. Financing these costs domestically is likely to increase government borrowing, thus increasing interest rates and further slowing recovery of the corporate sector.

In the short term, there is an urgent need to restructure the corporate and financial sectors. It is important to manage the crisis in such a way as to start the process of satisfying longer-term reform goals in each country, including making the fundamental changes necessary to create arm's-length relations between the government, corporations, and banks. Necessary steps include broadening the ownership of corporations by liberalizing foreign entry and expanding the role of capital markets. Protecting shareholder rights and developing improved accounting standards and bank regulations are essential. Just as the Great Depression led to legislation and reforms in the United States that diminished "relation-based" finance and laid the foundation for a modern financial structure, so the crisis in East Asia offers a rare opportunity for countries in that region to lay the foundation for a new, arm's-length system that is likely to be more efficient and sustainable.

The challenge for policymakers is to undertake comprehensive reform that maintains pressure on all parties in a way that promotes equitable burden sharing among borrowers, equity holders, the government, and external creditors; restores credit to viable enterprises and confidence in the financial system; and leads to a competitive corporate and financial system that minimizes the chances of recurrence of a crisis. Sustainable reform and the resumption of growth require a fair sharing of the burdens of economic restructuring among external participants (short-term creditors, equity holders, and bondholders) and

internal participants (shareholders, workers, and taxpayers). This burden sharing needs to be seen within the context of creating a future structure in which arm's-length relations prevail between new private sector owners, the government, sound financial institutions, and the broader capital market. The present constraints of meeting external debt payments and tight capital - adequacy ratios effectively determine the extent, pace, and costs (and, to a large extent, who bears these) of corporate and bank restructuring.

**Framework for Corporate Restructuring**

Corporate and financial restructuring takes time. In order to avoid an unnecessarily long period of uncertainty and slow growth, however, a country's government needs to enhance efforts to resolve these systemic problems. A comprehensive approach requires an active government that will eliminate obstacles to restructuring; facilitate both formal and informal debt workouts; and establish an effective new legal, regulatory, accounting, and institutional framework.

Obstacles to restructuring that need to be eliminated include tax policies that impede corporate reorganizations, mergers, debt-for-equity swaps, or debt forgiveness; restrictions on foreigners' participation as holders of domestic equity and investors in domestic banks; labor laws and other existing laws and regulations that could hinder debt restructuring; and ineffective bankruptcy procedures.

Effective bankruptcy procedures, which can be legally enforced and serve as part of a country's debt-restructuring process, are a very important means of ensuring that unviable firms do not continue to absorb credit. An effective bankruptcy system also serves to maximize the value of the assets to be distributed to creditors. Moreover, the presence of an effective bankruptcy system will create the appropriate incentives for creditors and debtors to reach out-of -court settlements. Given the costs and risks associated with even the most developed bankruptcy systems, a policy framework that facilitates out-of-court settlements that are fast, fair, and acceptable is essential.

Experience in several countries demonstrates that the government can play a constructive, yet informal role in facilitating an orderly workout of debts (sometimes referred to as the "London approach"). This approach, used in the United Kingdom since 1989, has been designed to help bring together debtors and creditors and facilitate negotiations. Many East Asian countries have adopted, or are adopting, a similar framework to facilitate and encourage corporate restructuring that includes using new bankruptcy provisions as an incentive for creditors and debtors to negotiate.

The government's policy framework should minimize costs to taxpayers. Because its primary focus is likely to be on large and medium-sized corporations, neither direct nor should indirect subsidies be provided to them. Small and medium-sized businesses require a different approach than large ones. Because many of the former have only restricted access to banks and capital markets, it is important to have policies in place that allow for rolling over their working capital and trade credit.

Policies are also needed to improve the competitiveness of the private sector. Competition policies that reduce anticompetitive practices and stop large firms' abuses of market power need to be implemented in parallel with corporate restructuring.

**Approaches to Corporate Restructuring**

Indonesia, Korea, Malaysia, and Thailand have all adopted an approach that facilitates and encourages corporate restructuring and have moved to eliminate obstacles to restructuring. The extent of progress and the degree of government involvement differ among countries, however, and are influenced by the share of corporate debt held by domestic banks versus foreign banks, whether domestic banks are institutionally strong enough to engage in active restructuring, and which sector the bad loans are concentrated in (real estate, commodity production, or manufacturing). In Indonesia, foreign private banks hold two-thirds, and domestic private banks hold about one-third, of corporate debt. In Thailand, foreign private banks hold about one-half the corporate debt. In Korea, most corporate debt is owed to domestic banks; similarly, in Malaysia, domestic banks hold about 90 percent of corporate debt.

In Indonesia, most corporate debt is owed directly by the borrowing firms to foreign banks.

The weak domestic banks and their small share of total corporate debt imply that foreign banks will be an important player in the process. The authorities have adopted a three- pronged restructuring approach that consists of a framework to facilitate workouts on a voluntary basis, an improved bankruptcy system, and provision of foreign exchange risk protection once a restructuring agreement is reached. To support this process, the authorities are also eliminating regulatory obstacles to corporate restructuring.

**Divestment**

In finance and economics, **divestment** or **divestiture** is the reduction of some kind of asset, for either financial or social goals. A divestment is the opposite of an investment.

**Divestment for Financial Goals**

Often the term is used as a means to grow financially in which a company sells off a business unit in order to focus their resources on a market it judges to be more profitable, or promising. Sometimes, such an action can be a spin-off. A company can divest assets to wholly owned subsidiaries.

Either the prime objective for divestment may be the assets being sold does not conform to the overall business strategy or they fail to meet the group hurdle rate. They are often a cheaper and cleaner alternative than closure of the unit.

It is very important to calculate the financial effect of divestment before any final decision is made based on the two aspects stated above. The evaluation will take the form of a comparison of the potential price available for the relevant business unit and the financial effect on the remainder of the group, against the financial return available from the business unit if it were retained. The divestment decision should only be made if the returns of the business unit as retained as compared with the disinvestment opportunity cost. For example, if a division of a group is earning 12% as compared to group return of 18%, then it should be disposed off.

However, the cost of asset and price available for sale must be compared and evaluated before the decision to sell.

For example, if an asset or group of assets costing Rs 100,000 is earning 12% or 12000 and could be sold for 60,000/-. The group hurdle rate is 18%. Comparing 12,000 with 80,000, then ROCE is 15% (12,000/80,000) and is under group hurdle rate of 18%, therefore, it can be disposed off.

However, if the offer price of asset in question is 50,000, the ROCE is 24%, which is well above the group’s rate of return of 18% and the asset in question should not be disposed off.

**Divestment for Social Goals:**

Although these types of divestments are for social purposes, yet they have financial repercussions. The term also refers to the reduction of investment in firms, industries or countries for reasons of political or social policy.

**Examples**

Examples of divestment for social reasons have included:

* The withdrawal of firms from South Africa during the 1980s due to Apartheid
* Discussion over whether it is ethical to invest in companies that sell tobacco

**Definition of buyout**

Buyout is defined as the purchase of a company or a controlling interest of a corporation's shares or product line or some business. A leveraged buyout is accomplished with borrowed money or by issuing more stock.

The purchase of a company or a controlling interest of a corporation's shares.

**Management Buyouts**

Management buyouts are similar in all major legal aspects to any other acquisition of a company. The particular nature of the MBO lies in the position of the buyers as managers of the company and the practical consequences that follow from that. In particular, the due diligence process is likely to be limited as the buyers already have full knowledge of the company available to them. The seller is also unlikely to give any but the most basic warranties to the management, on the basis that the management knows more about the company than the sellers do and therefore the sellers should not have to warrant the state of the company.

In many cases, the company will already be a private company, but if it is public then the management will take it private.

**Reasons for Buyouts:**

The existing parent company of the victim firm may wish to dispose of it. The parent company may be caught up in financial distress and is in acute need of cash and liquidity. The subsidiary on the other hand, is not strategically fit with parent’s overall business strategy.

In case of loss making, selling the unit to its management may be the better option than to dispose or putting into liquidation, which has it own costs.

The purpose of such a buyout from the managers' point of view may be to save their jobs, either if the business has been scheduled for closure or if an outside purchaser would bring in its own management team. They may also want to maximize the financial benefits they receive from the success they bring to the company by taking the profits for themselves.

**Private Equity Financing**

The management of a company will not usually have the money available to buy the company outright themselves. While they could seek to borrow from a bank if the bank accepts the risk, they will commonly look to private equity investors to back their buyout. They will invest money in return for a proportion of the shares in the company, and sometimes also grant a loan to the management.

Private equity backers are likely to have somewhat different goals to the management. They generally aim to maximize their return and make an exit after 3-5 years while minimizing risk to them, whereas the management will be taking a long-term view. While certain aims do coincide - in particular the primary aim of profitability - certain tensions can arise. The backers will invariably impose the same warranties on the management in relation to the company that the sellers will have refused to give the management. This "warranty gap" means that the management will bear all the risk of any defects in the company that affects its value.

As a condition of their investment, the backers will also impose numerous terms on the management concerning the way that the company is run. The purpose is to ensure that the management runs the company in a way that will maximize the returns during the term of the backers' investment, whereas the management might have hoped to build the company for long-term gains. Though the two aims are not always incompatible, the management may feel restricted.

**Leveraged Buyout – LBO**

The acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition. Often, the assets of the company being acquired are used as collateral for the loans in addition to the assets of the acquiring company. The purpose of leveraged buyouts is to allow companies to make large acquisitions without having to commit a lot of capital.

In an LBO, there is usually a ratio of 90% debt to 10% equity. Because of this high debt/equity ratio, the bonds usually are not investment grade and are referred to as junk bonds. Leveraged buyouts have had a notorious history, especially in the 1980s when several prominent buyouts led to the eventual bankruptcy of the acquired companies. This was mainly due to the fact that the leverage ratio was nearly 100% and the interest payments were so large that the company's operating cash flows were unable to meet the obligation. It can be considered ironic that a company's success (in the form of assets on the balance sheet) can be used against it as collateral by a hostile company that acquires it. For this reason, some regard LBOs as an especially ruthless, predatory tactic.

**Employee Buyout – EBO**

A restructuring strategy in which employees buy a majority stake in their own firms. This form of buyout is often done by firms looking for an alternative to a leveraged buyout. Companies being sold can be either healthy companies or ones that are in significant financial distress.

For small firms, an employee buyout will often focus on the sale of the company's entire assets, while for larger firms; the buyout may be on a subsidiary or division of the company. The official way an employee buyout occurs is through an employee stock ownership plan (ESOP). The buyout is complete when the ESOP owns 51% or more of the company's common shares.

**Management Buy In (MBI):**

Management Buy in (MBI) occurs when a manager or a management team from **outside** the company raises the necessary finance buys it and becomes the company's new management. A management buy-in team often competes with other purchasers in the search for a suitable business. Usually, a manager will lead the team with significant experience at managing director level.

The difference to a management buy- out is in the position of the purchaser: in the case of a buy-out, they are already working for the company. In the case of a buy-in, however, the manager or management team is from another source.

Some of the private equity groups and executive search firms that focus on management buy-ins.

**Spin out**

To rotate out of control, as a skidding car leaving a roadway.

**Factors to be considered in Management Buyout**

A management buyout occurs when incumbent **management** takes ownership of a firm by purchasing a sufficient amount of the firm's **common stock.** These transactions vary due to the conditions under which the firm is offered for sale and the method of financing employed by the managers.

Consider the conditions that may encourage managers to purchase a controlling interest in the firm's stock. The owners of a corporation are its stockholders. These stockholders are concerned with increasing the value of their investment, not only in one specific firm, but for all investments. Therefore, if a majority of the firm's stockholders perceive that the value of their investment will be enhanced by agreeing to be acquired by another firm, they will elect to sell their stock to the acquiring firm at a price they consider fair. Managers of a firm may consider this transfer of ownership a benign event.

 They may also, however, be concerned that the new owners will not manage the firm most efficiently, that they will have less control over the management of the firm, or that their jobs will be less secure. In this situation, the current managers of the firm may consider purchasing the firm themselves.

Another situation that frequently leads to management buyouts is the case of financial distress. If the firm is having serious difficulties meeting its financial obligations, it may choose to reorganize itself. This can be done by closing failing operations to slow the drain on financial resources and by selling profitable operations to an outside party for the cash needed to restore financial viability to remaining operations. It is not uncommon for firms in this situation to give managers of the divisions being divested the opportunity to buy the assets. This makes sense for two reasons. First, management probably has the greatest expertise in managing the subset of assets offered for sale. Second, it saves the cost of searching for an external party with an interest in the division, for sale.

Once incumbent management has decided it is interested in purchasing the firm or a particular portion of the firm, they must raise the capital needed to buy it. Managers in many corporations are encouraged to become stockholders in the firm by including stock and the option to buy more stock as part of their compensation package. The non-management stockholders, however, will expect some compensation from this sale and the value of manager-owned stock is not likely to be sufficient to finance the purchase of the firm or one of its divisions.

This means that managers must raise cash from other sources such as personal **wealth.** If managers have sufficient capital in other investments, these can be sold and used to finance theremainder of the purchase price.

While a management buyout is relatively straightforward when managers have sufficient personal capital to meet the purchase price, the more common scenario requires managers to borrow significant amounts. It is not un-common for managers to **mortgage** homes and other personal assets to raise needed funds, but in many transactions, these amounts are still not sufficient. In these cases, managers will borrow larger amounts using the assets of the firm they are acquiring as collateral. This type of transaction is called a **leveraged buyout,** or LBO. The LBO is a common form of financing for large transactions. It providesthe management team with the financing needed to control the assets of the firm with only a small amount of equity. Nevertheless, the new firm that emerges from this transaction has very high financial risk. The large amounts of **debt** will require large periodic payments of interest. If the firm cannot meet this obligation during any period, it can be forced into bankruptcy by the debt holders.

This description of a management buyout can be generalized to define an employee buyout. In some situations, it is feasible that all employees, not just a small group of managers, can collectively purchase a controlling interest in a firm's stock. This may be the long-term result of a carefully designed employee stock ownership plan (ESOP), that management has instituted. It may also result from the pressures of financial distress. In 1994, United Airlines was faced with declining profits and strained relations with labor. Management and labor eventually agreed on a swap of wage concessions for a 55 percent equity stake in the firm. In the five following years, the firm became more profitable, the stock price rose significantly, and employees retained a controlling interest in Unity’s common stock.

It is important to note that managers (or employee owners) are no different than other investors. They will assess the **risk** and rewards associated with a buyout, leveraged or otherwise, and will act in their own best interests. As managers, they have specialized knowledge of the firm that may prove advantageous in charting a future course of action for the acquired firm. By assuming ownership of the acquired firm, they will also assume a riskier position personally. If the potential rewards associated with control are perceived as adequate compensation for this risk, then the management buyout will be source of financial distress.

**Sources of Financial Distress:**

A situation in which available cash is insufficient to pay supplier, vendors, employees, banks and creditors is known as financial distress. Signs of first-stage distress include negative net cash flow and earnings and a falling market equity value. If this situation persists, then management must take actions to rectify it. The second-stage signs of distress include managements’ attempt to reduce costs, such as employee lay off and plant closing.

If this situation goes on, the firm enters the third and final stage of distress marked by delayed and small payments to creditors and vendors, employees and others. This may also include of sale of assets, issuing loan stocks and rescheduling payment with creditors and banks. If these actions do not alleviate the financial sufferings and the firm is likely to embrace the bankruptcy – the eventual result of financial distress.

A firm incurs several costs when its financial position deteriorates, even if the firm does not declare bankruptcy. These are called costs of financial distress. Bankruptcy involves additional fatal costs. As a general definition, any loss of value that can be attributed to a firm’s financial strength is a cost of financial distress. These can be classified into three categories:

* In terms of favours to stakeholders to offset them for the risk of doing business with financially sick firm
* Loss of competitive edge in product market
* Loss of tax shield available

In the next hand out we shall cover the sources of financial distress in detail.