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VALUE CREATION THROUGH CORPORATE RESTRUCTURING A CASE OF “NATRON – HAYAT”

SUMMARY

This paper focuses on a restructuring process from several aspects, but in essence it considers its main objective - value generation and increase. First, it introduces the basic concept of restructuring and a brief theoretical background of its importance. This process is determined by several causes of company distress, the situation that precedes the necessity to restructure. In order to accomplish a successful restructuring, one should be familiar with techniques and methodology required for objectives defined prior to the implementation phase. The core interest of any restructuring process is a company value increase. Therefore, the basic understanding of the value concept and its estimate is needed. In order to provide not only theoretical framework for this very process, but also a practical view of its possible range, the paper contains a brief flow of significant activities, both prior and during the restructuring process of the “Natron dd Maglaj” company. It reveals the trend of a free cash flow, a widely used measure of a value creation, made by a company founded through the venture of “Natron dd Maglaj” and “Hayat Holding”, a Turkish investor elected to manage the restructuring project. Findings of the paper show real potentials of the restructuring process once it is properly carried out and managed within acceptable assumptions even in almost inevitable company failure situation, as in the case of “Natron dd Maglaj”.

Key words: company, distress, restructuring, performance, value

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1. INTRODUCTION

Restructuring as a process is a relatively new focus of academic community. It is inspired by a growing trend of its use when companies face a distress situation. This is particularly the case in the last three decades, marked as a period experiencing the use of wide range of techniques to create preconditions for a company survival and avoidance (or acceleration if recommended as the only option) of liquidation. Whitman and Diz (2009, p.3) emphasize “three earthshaking events” that have created a quite changed financial environment and made restructuring quite a natural development option: financial innovation, more flexible rules and regulations and financial meltdown... We would like to add the forth one that took place in the early 90’s, although its title is not finance in a direct sense: privatization of the state owned and restoration of the market economy. An efficient and effective company restructuring has not only a tremendous impact on increasing the chance a company needs to survive. It also creates or restores the company value, what from an investor’s perspective seems to be the main trigger for a comprehensive restructuring process. To create value through corporate restructuring, one assumes a significant performance improvement. This improvement should have an impact on a free cash-flow generation, a moment of the utmost importance to investors in long-term.

First, the paper contains a short theoretical background on corporate restructuring, value estimation and creation. It also provides a framework on conditions underpinning, methods and techniques used and possible expected objectives in the restructuring process. Particularly, we introduce ownership change, i.e. privatization through restructuring, the main tool used in a restructuring case that we here review.

Furthermore, we focus on probably the most successful case of company restructuring related to the transitional process in Bosnia and Herzegovina – a company of “Natron-Hayat ltd”, Maglaj.

We describe major conditions that induced the “Natron” restructuring, challenges being faced and methodology used to accomplish this very complex restructuring process.

Finally, we review the value creation trend in five years of the post-restructuring period by examining cash-flow performance as a key focus of investors.

2. Restructuring Process

Any significant shift of a company assets composition, liabilities structure or external financing conditions is considered restructuring. In other words, whenever a company carries out operations to create quite a different asset or capital structure, it is exposed to it. However, the restructuring may be executed over the company by its shareholders. Thus, this process can take place having the company both as a subject and object of restructuring. When a company is a subject, then restructuring is conducted by its management. Otherwise, it is conducted by investors. Operating in a very turbulent environment requires frequent considerations to the necessity to restructure. Therefore, the restructuring is not always a response to worsen a company's position. In recent years, it appears to be a part of regular investors and management interest. However, if and when a company faces serious negative trends, and consequently poor operating and financial performance, the restructuring is inevitable. Therefore, a company should restructure whenever it faces challenges of distress.

Bad company performance and a consequent threat to its financial position urgently requires a specific restructuring plan. Among most general causes of a company distress we find 1) the lack of flexibility to market changes and demands, 2) improper asset management, 3) excessive external financing, 4) vague ownership structure and 5) agency challenges.

When in distress, a company faces an inadequate asset composition to carry out its core business operation, reduction of sales, growing debts and consequently insolvency, loss of capable workforce, etc. Many of the mentioned consequences come together and if not prevented they bring a company into liquidation. In order to avoid the most negative scenario, a company is exposed to an uncommon, strategic operations aiming to remove basic negative impacts. In practice, under restructuring we may find projects such as mergers, acquisitions, leveraged buy-outs (LBO), management buy-outs (MBO) and divestures (company sales, spin-offs, curve-outs, partial liquidations).

In the last two decades, the world has experienced a global transition process known as the ownership transformation or privatization. The process has been designed by state decision makers in former communist countries with the main objective to establish an efficient market economy. In essence, it created a trigger for restructuring. Many academic papers addressed the issue whether privatization can be used as a tool for efficient restructuring. However, findings of the researches show different results. Some of them suggest the necessity to conduct the so called first privatization, i.e. sole ownership transfer, while the second privatization should be used as a real restructuring of capital and consequently asset composition. Other findings recommend the use of privatization for essential restructuring to avoid a non effective period between the first and second phase of this very process. Since there may be found a few serious works on the concept and potentials of privatization through restructuring or vice versa, we believe this paper can serve as an additional useful view in this regard, emphasizing the restructuring by a joint venture redesign of asset composition, i.e. special case of divesture.

3. Value Creation and Estimate

Prior to focusing on the main object of this paper, we have to address another important subject - concept of value creation and estimate. The value creation is a core interest of investors who, whether directly or not, impose a tremendous impact on the restructuring processes. Restructuring with no expectation of new value to be created does not make sense. The most prominent performance in the value creation is that of a cash-flow. Although, there are also some other opinions and views related to the concept of value such as that of Whitman and Diz (2009, p.134), who describe their value approach as "less a matter of a general principle and more a matter of understanding the business and valuing both the going concern as well as its resource conversion attributes", the vast majority of academics emphasize the cash-flow or, more precisely, free cash flow as the real value measurement. Free cash-flow (FCF) is money which a company makes available to cover claims of investors and for strategic investments. The formula to calculate the FCF is:

FCF = EBIT (1-t) – Net investments in operating capital[3]

Where EBIT is earnings before interest and tax, while "t" is tax rate on net-profit. The net investment in an operating capital is a difference between the net operating capital of the current and previous year, while the operating capital is operating assets minus operating current liabilities. The term "operating" is used to define assets related to operation (excluding financing) and current liabilities

[3] Ehrhardt, C.M., Brigham, F.E.,. Financial Management: Theory and Practice, 2011, page 62

except external contractual financing. When estimating investment value, one calculates the present value of expected FCF for a certain period and expected terminal value of the investment. Therefore, the process of a value estimate is straightforward: i) calculate discounted value of projected FCF plus terminal value of investment and ii) compare it to the initial capital outflow. The difference, if it exists, determines the value creation.

4. “Natron – Hayat” Joint Venture

Besides all the described situations that lead towards company restructuring, there is also one which is caused by the challenge of a market economy restoration in the South East Europe and, for the purpose of this paper, more precisely Bosnia and Herzegovina.

Namely, the privatization as the main feature of transition is in essence a restructuring process. Most companies to be privatized face a distress situation prior to the privatization. The same case occurred to a well known pre-war cellulose production shareholder company “Natron dd Maglaj”. Facing numerous and unable to respond adequately due to many reasons, this company found itself in a situation almost impossible to overcome.

In brief, we describe conditions prior to restructuring:

- technology unused more than a decade required a tremendous investment plan;
- inability to produce cellulose as long as the investment plan is not implemented;
- non existing market;
- excessive workforce;
- undeveloped concept of raw material supply;
- mixture of two bad ownership components: state (70%) and more than a thousand of small shareholders (30%);
- tremendous losses incurred.

During the war, technology was hardly damaged and devastated (war damage was estimated to 30 mil BAM). In the meantime, due to the inability to invest in the reconstruction and procurement of new machinery, it became old and uncompetitive. A feasibility study prepared at that time showed with no doubt that "Natron" would have had a perspective but only under a comprehensive integral production restart.[4] The technology had to be significantly improved and modernized in order to increase production quality with significantly lower production costs.

Until the early 90's, "Natron" mostly served the market of former Yugoslavia as an exclusive and protected supplier of consumers situated there. A minor part of its products was exported to the neighbouring countries. Due to several reasons, those markets were entirely and forever lost, but the main one was related to the mergers of sucks producers executed by "Natron" competitors. However, the study has also indicated "Natron's" competitive advantages once it is able to produce its base product structure.

An excess of workforce was one of the main challenges prior to the critical restructuring phase. Actually, in 2001 the number of employees was extraordinary high - 1906. No serious investor could be found to accept this burden once the divesture was accomplished. On the other hand, a huge reduction of workforce as a precondition to establish a joint venture or any other type of restructured company would be unpopular and a possible cause of the failure of the venture.

"Natron dd Maglaj" was out of its core business operation for a decade, having no need to develop any concept of raw material supply. Thus, in order to create a sustainable cellulose production, this had to be regarded as inevitable.

30% of shares held by small shareholders were an inappropriate fact due to at least two reasons. First, the decision to divest "old" Natron required either consensus of all the shareholders or money to redeem shares from all the shareholders who would possibly vote against the divesture of the company. The first scenario was "free of charge", but conditioned with an anonymous decision of shareholders assembly. The second one could possibly be focused on two issues: i) which source should be used to redeem the shares and ii) what would be the value of shares in a non-active financial market. The latter would probably cause a court dispute and prolong the project implementation for an uncertain period of time. It is unlikely to expect anything but failure if this scenario would occur.

Obviously, "Natron" was exposed to high reported losses that from investors' perspective created a further sense of unwillingness to engage.

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[4] The entire product structure to ensure profitable operations includes: unbleached softwood pulp, exstensible paper for sacks, packaging papers and corrugated board.

Simultaneously, successful company privatization was challenged by several serious issues:

- strict regulation of privatization affairs;
- lack of potential investors;
- decentralized organization of public companies to provide cellulose wood;
- necessity to provide multi-level government commitments upon privatization.

Complex restructuring decisions are usually made under public influence. As they naturally involve certain unpopular compromises over expectations of both sides - investor and company representatives - decision makers are not willing to disclose them in details unless they are obliged to do so. This is the main reason why literature on comprehensive restructuring cases is poor, although with few exceptions (Gilson, 2010). Privatization of companies is regulated by law everywhere, since it is inspired by political changes. Thus, the framework to privatize, restructure, divest or exercise any other way of an ownership transfer is strictly designed and therefore no room for undisclosed decisions exists. In the case of “Natron”, many decisions were needed to provide mutually acceptable scope of restructuring or divesture activities. And they were all to be disclosed to the main stake holders including trade unions, small shareholders and different government levels.

At time prior to that, restructuring investors showed no serious sign of interest in this company and this was likely to be expected. In very few cases there have been some initial discussions, but after exchange of rather unrealistic views they failed. In order to even start a negotiation on “Natron” restructuring, many preconditions to attract investors were to be created.

Among those of utmost importance were:

- willingness of government as a majority owner to negotiate, not to impose solutions;
- readiness to accept modern approach toward value estimate;
- flexibility toward investors’ special requests and expectations;
- capability to mobilize all stakeholders from “Natron” side;
- commitment to some of the terms of restructuring contract.

4.1. Restructuring Preparation Activities

In 2001, a strategic mid-term restructuring was done to prepare the company for the foregoing privatization and attraction of serious investor. The basics of the plan were:

- Workforce optimization;
- Productivity increase on the existing technology based on old paper and imported cellulose with permanent cost reduction and turnover increase;
- Non negative cash-flow from an operational activity objective;
- Feasibility study creation to prepare the foundation for comprehensive investment and production restart;
- Small scale privatization to sell off assets unnecessary for core business in order to get cash inflow and employees reduction;

At the end of 2001, the number of employees in old the “Natron” was 1960. During 2002, a comprehensive reduction workforce plan was implemented and remarkable result achieved – number of employees reduced to 1.190. During the next three years of this pre-restructuring phase, another 386 workers were situated through several projects, including a retirement plan and small scale privatization. Thus, a crucial phase of negotiations with potential investors was no longer burdened with significant excess of workforce.

No one could predict the time and manner to restructure “Natron dd Maglaj”. However, in order to draw someone’s attention, besides workforce optimization, a certain production level was needed. Therefore, the years preceding the crucial restructuring phase were used to increase production, lower costs and simultaneously increase productivity of existing facilities.

A brief comparison of the ratio between turnovers in those years and costs of goods sold clearly shows the efforts spent in order to achieve this objective:

Table 1 Productivity Increase During Pre-Restructuring Phase

	2001	2002	2003	2004
Annual Turnover	20.433.526	27.100.475	28.423.484	32.903.351
Costs of Goods Sold	27.466.007	30.576.613	32.280.861	36.062.418
AT/CGS (%)	74,40	88,63	88,05	91,24

Source: “Natron dd Maglaj” annual reports

Although negative in all the years, productivity has been significantly improved from 74% coverage of direct costs in 2001 to 91% in 2004, a year that precedes the divesture.

One of the major impacts of losses incurred in the years of our concern was a huge amortization (non financial cost). Among objectives set in 2001, there was also a non negative cash-flow from operation, i.e. having no significant changes in operating working capital the objective was to cover losses by the amortization costs.

In Table 2 we present the results achieved with a brief comment following:

Table 2 Net Cash Flow during Pre-Restructuring Phase

	2001	2002	2003	2004
Loss	10.301.716	5.647.551	7.267.550	8.647.872[5]
Amortization	10.436.682	7.543.073	7.382.034	8.485.127
Amortization - Loss	134.966	1.895.522	114.484	-162.745

Source: "Natron dd Maglaj" annual reports

With certain caution regarding the figures presented, one can assume a successful achievement of this objective too.

In 2001 and 2002, two simultaneous feasibility studies were created to examine the potentials of "Natron dd Maglaj" and a possibility of its full recovering. Both studies showed the real justification to restart the integral production facilities and profitability of this venture once it was accomplished.

Finally, small scale privatization launched at that time was used to provide cash for some production restoration investments and workforce optimization objectives.

4.2. Restructuring Divesture

Having all of the above mentioned preparations done, preconditions to inviting potential investors have been prepared. Despite prior workforce optimization, feasibility studies justification, essentially non negative financial results, it took almost two years to complete the complex divesture plan following three basic

[5] The reported loss in 2002 is much higher (20.472.803 BAM) but 11,8 mil. BAM reffers to the liabilities increase imposed by first auditors report (liabilities incurred in years preceding the reporting)

cornerstones: 1) rules and regulations to implement the restructuring, 2) assumptions imposed by an investor and 3) minimal requests imposed by "Natron".

Privatization rules and regulations in Bosnia and Herzegovina never allowed for discrete negotiation procedures. Although two Natron's tender procedures have been completed unsuccessfully, any other option to continue with its privatization was possible only through a transparent and strictly defined sequence of activities. Thus, every decision regarding a value estimate, commitments, projects determination and roles of stakeholders had to be fully disclosed at the time of joint venture or more precisely divesture accomplishment. In this very case, a direct negotiation with potential investors has been selected as the optimal legal framework and this, in turn, enabled more potential investors to participate regardless the level of seriousness and strength. However, at the time of trigger pooling, there was at least one serious announcement and it provided an incentive to continue with the formal invitation.

Very tough negotiations have preceded the formal procedure launching. The most difficult issue to resolve was that of a cellulose wood supply. "Hayat – Holding", the investor which was finally elected to implement the restructuring process, requested from the government to provide guaranties for permanent supply of the joint venture company, both in terms of quantities needed and a raw material price stability. Both requests were difficult to accept and negotiations almost failed even before the official invitation to investors occurred. When a compromise on this issue was reached, the acceptable solutions for all other investor's requirements (investment guaranties, majority ownership, initial value estimate, general government support, etc.) have also been placed.

During the negotiations, some requirements were also imposed by "Natron". They dealt with workforce keeping program guaranties, covering bank and major portion of employee liabilities incurred in the previous time period.

The restructuring of the Natron potentials was carried out through a joint venture of the two companies. In that venture, "Natron dd Maglaj" invested all its assets, while the Turkish company invested 20 million BAM. Some inevitable liabilities of "old" Natron were also included. The new venture assumed employment of all the employees of "Natron dd Maglaj". To the Turkish investor, 70% ownership majority has been assigned in exchange for the commitment to invest an additional 40 million BAM in an integral production restart[6]. There were also some other minor commitments to support basic objectives of the joint venture contract, which are beyond the scope of this work. The deal was concluded on February 3rd, 2005 by signing the Joint Venture Contract and basically creating a real divesture of “Natron dd Maglaj”. The new company’s name was “Natron-Hayat ltd Maglaj”.

4.3. Value Concept of the Venture

4.3.1. Initial Value

Initial value of the new company was 26 million BAM to reach the ratio of 70%:30% in favour of the Turkish investor. Thus, in order to meet the initial input of the financial commitment and mentioned ownership ratio, “Natron” had to “create” the 6 million BAM value of its fixed assets. Here a simple DCF concept of the free cash-flows or any other concept of a value estimate was difficult to apply since it had to be assumed. However, the value determined was not far from its liquidation value in the case of “Natron”, in long term failed to restructure. Adding to the commitments and obligation of the new company to buy the existing 4 million BAM worth of inventories in order to cover bank liabilities and mortgages and predicted 18 million BAM value of Natron’s share in the new venture[7], one can assume a correct initial value estimate of the “Natron” fixed assets.

4.3.2. Venture Value Creation

As indicated earlier, a free cash-flow is the best indicator of the value available for investors. In order to present the FCF in this case we provide the figures of the FCF from the entire first year of the venture business until the last official reporting data (semi-annual 2011 report). The free cash flow contains two components. The first is earnings before interest and tax corrected by (1-t), where “t” is the profit tax rate. The second one is net change of the operating capital employed to support business operation of the company.

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[6] The realized investments four times higher then contractual investment commitments, i.e. in the time period May 2005-May 2008, 127.3 million BAM were invested in fixed assets and additional 50 million BAM in current assets.

[7] At time of the paper writing, two thirds of Natron's shares in the new company was already sold to the Turkish investor for 12 million BAM, out of which the first deal (6 million BAM) was defined as obligatory in the Contract.

We have explained earlier how both components of the FCF are calculated. However, here we exclude (1-t) from the first one since the "Natron-Hayat", as an export oriented company, is under a free tax treatment according to the existing law. Also, we exclude huge depreciation changes as they have neutral impact on the FCF generation.

To get the operating capital, in the following table we have used data on company total assets (as they are all operational) and deducted this figure by operating liabilities (excluding those of financial nature). We got the net change of the operating capital as the difference between the current and previous year operating capital amount.

The next Table provides the "Natron-Hayat" figures of the free cash flow, beginning with the year 2006, including the recent semi-annual figures in 2011.

Table 3 Free Cash Flow Trend during Post–Restructuring Phase

	2006	2007	2008	2009	2010	1-6 2011
EARNINGS	-2.437.729	-4.627.765	-16.799.597	-34.806.883	-2.337.782	8.539.156
INTEREST	358.856	381.525	9.326.669	12.200.871	6.487.193	1.096.192
EBIT	-2.078.874	-4.246.240	-7.472.928	-22.606.012	4.149.411	9.635.348
Operational assets	46.193.122	128.240.766	129.305.777	113.039.674	98.053.379	90.766.933
Operational liabilities	16.630.960	20.220.673	16.371.105	17.974.740	12.122.279	13.570.919
OA-OL	29.562.162	108.020.093	112.934.672	95.064.934	85.931.100	77.196.014
ΔOperational capital		78.457.931	4.914.579	-17.869.738	-9.133.834	-8.735.086
FCF		**-82.704.171**	**-12.387.507**	**-4.736.274**	**13.283.245**	**18.370.434**

Source: "Natron-Hayat" annual reports and authors computation

The data in the Table clearly indicate an upward trend of the value creation assuming a huge cash-outflow at the beginning of the project implementation. The trend is so straightforward that no additional explanation is needed to clarify it. Important notions on causes and conditions of the value trend experienced in this case are described in the concluding remarks.

5. CONCLUDING REMARKS

The restructuring becomes an operational activity more and more, as companies face the most turbulent environment in the last thirty years. This requires an understanding of techniques, methodology and scope of different assets and/or liabilities structural changes. The "Natron – Hayat" joint venture is a very special case of restructuring, since it faces not only common challenges of distress but simultaneous issues of privatization as well.

In order to conduct a successful restructuring operation with external investor engagement findings of this paper, we recommend several important notions.

First, a comprehensive preparation of conditions to implement the restructuring plan is needed in order to provide a common faith in the project's success. If the restructuring is a one sided initiative, it will probably fail.

The value estimate has to be carefully conducted. In order to achieve a mutually acceptable initial value, only a limited use of the models matters. From the company perspective, the DCF model combined with the use of the liquidation model appears to be the most realistic approach. However, a certain flexibility must be shown to reach the required ownership share and capital value supporting it. In the case of restructuring, a strategic investor takes a bit different approach towards a value estimate than an institutional investor. The concept is a long-term value creation rather than pure short-term expectation of the cash-flow.

Flexibility to negotiate contractual terms of the restructuring is crucial. Although some decisions can be extremely unpopular, the approach to find solutions for all reasonable requests has no alternative.

The case that we have examined serves as a pure example of successful restructuring and concluding remarks that hereby emerge might contribute to a future practical use and theoretical research on this particular issue.

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