Chapter 4

Corporate Restructuring and Value Creation

4.1. Introduction

Restructuring is widely used in both the developed and developing countries nowadays. Companies and economies are restructuring to achieve a higher level of performance or to survive when the given structure becomes dysfunctional.

Restructuring takes place at different levels. At the level of the whole economy, it is a long-term response to market trends, technological change, and macroeconomic policies. At the sector level, restructuring causes change in the production structure and new arrangements across enterprises. At the enterprise level, firms restructure through new business strategies and internal reorganisation in order to adapt to new market requirements.

In section 4.2, we define restructuring and value creation and then in section 4.3, we discuss restructuring and value creation of enterprises in developed economies and in section 4.4, we present restructuring and value creation models. In section 4.5, we present restructuring and value creation of enterprises in transition and in section 4.6, we analyse when to restructure the enterprise in transition. Finally, in section 4.7, we conclude the chapter by highlighting the main points and analysing the lessons learned form the experiences of developed and transition economies.

4.2. Definitions of Restructuring and Value Creation

“The word structure used in an economic context implies a specific, stable relationship among the key elements of a particular function or process. To restructure means the (hopefully) purposeful process of changing the structure of an institution (a company, an industry, a market, a country, the world economy, etc.) [Sander et al., 1996, p.1].” This structure defines the constraints under which institutions function in their day-to-day operations and their pursuit of better economic performance. Restructuring can therefore be interpreted as the attempt to change the structure of an institution in order to relax some or all of the short-run constraints. Restructuring is concerned with changing structures in pursuit of a long-run strategy. Crum & Goldberg [1998, p.340] define restructuring of a company as “a set of discrete decisive measures taken in order to increase the competitiveness of the enterprise and thereby to enhance its value”. In this study, we define restructuring as a change in the operational structures, investment structures, financing structures and governance structure of a company. The objective of restructuring is to transform the company into an enterprise that is of high value to its owners.

McTaggart, Kontes and Mankins [1994] define value creation as managing the performance of individual business units with respect to the cash flow generated or rates of return earned over time. In our study, the term value creation refers to improvements of the return on investment of owners by increasing the cash inflows and reducing risk. The value created in a business is measured by comparing the rate
of return on assets (ROA) to the cost of capital (k) of a company. Value is created only when a business unit or a company can earn a return on assets that exceeds its cost of capital; when return on assets (ROA) falls short of the cost of capital, value is destroyed.

4.3. Corporate Restructuring and Value Creation in Developed Economies

The literature review on restructuring and value creation in the developed economies provides insight in the experience of success or failure of restructuring actions taken by management in creating value and the determinants of value in a business. These experiences can be useful for countries in transition in the Central and Eastern Europe and Sub-Saharan Africa too because the main goal of privatisation and restructuring enterprises is to transform the entities into value creating capitalist firms.

Restructuring involves diverse activities such as divestiture of underperforming business, spin-offs, acquisitions, stock repurchases and debt swaps, which are all a one time transaction, but also structural changes introduced in day-to-day management of the business. Rappaport [1986] classified the above listed one time transactions as Phase I restructuring and those changes that bring continuous value improvement through day-to-day management of the business as Phase II restructuring. Rappaport [1986] argues that companies need to move from Phase I restructuring to Phase II because in Phase II, the shareholder value approach is employed not only when buying and selling a business or changing the company’s capital structure, but also in the planning and performance monitoring of all business strategies on an on-going basis. A successful implementation of Phase II restructuring not only ensures that management has met its responsibilities to develop corporate performance evaluation systems consistent with the parameters investors use to value the company, but also minimises the Phase I concern of managers that a hostile take-over is imminent.

Copeland, Koller and Murrin [1990] also argue that managers should restructure companies to improve value, otherwise, external raiders will get an opportunity to take-over the company. Therefore, they claim that it is in the best interest of both managers and shareholders to keep the gap between potential and actual value as close as possible. Management can improve operations by increasing revenue or reducing cost, acquiring or disposing of assets and improving the financial structure of the company.

Company executives often restructure their companies for enhancing productivity, reducing costs or increasing shareholder wealth. Bowman, et al. [1999] summarised the findings of the corporate restructuring literature of 1990s that examined the impact of restructuring on performance. They classified restructuring activities into three categories, portfolio restructuring, financial restructuring and organisational restructuring.

*Portfolio restructuring* includes significant changes in the mix of assets owned by a firm or the lines of business in which a firm operates, including liquidation, divestitures, asset sales and spin-offs. Company management may restructure its business in order to sharpen focus by disposing of a unit that is peripheral to the core
business and in order to raise capital or rid itself of a languishing operation by selling-off a division. Moreover, a company can entail on an aggressive combination of acquisitions and divestitures to restructure its portfolio. According to the findings of Bowman et al. [1999] spin-offs and sell-offs generate gains while acquisitions and divestments generate no improvements on average. Of course these results have differed over time [Baker, 1992] and also possibly over countries.

Financial restructuring includes significant changes in the capital structure of a firm, including leveraged buyouts, leveraged recapitalisations and debt for equity swaps. Financial structure refers to the allocation of the corporate flow of funds-cash or credit-and to the strategic or contractual decision rules that direct the flow and determine the value-added and its distribution among the various corporate constituencies. According to Donaldson [1994, p. 7], “the elements of the corporate financial structure include the scale of the investment base, the mix between active investment and defensive reserves, the focus of investment (choice of revenue source), the rate at which earnings are reinvested, the mix of debt and equity contracts, the nature, degree and cost of corporate oversight (overhead), the distribution of expenditures between current and future revenue potential, and the nature and duration of wage and benefit contracts.” The findings of Bowman et al. [1999] revealed that financial restructuring generates economic value. A large part of the financial restructuring studies included were leveraged buyouts (LBO) and management buyouts (MBO). This evidences that managers have much more information about the true value of the firm’s assets than outsiders.

Organisational restructuring includes significant changes in the organisational structure of the firm, including redrawing of divisional boundaries, flattening of hierarchic levels, spreading of the span of control, reducing product diversification, revising compensation, streamlining processes, reforming governance and downsizing employment. The findings of Bowman et al. [1999] indicated that lay-offs unaccompanied by other organisational changes tend to have a negative impact on performance. Downsizing announcements combined with organisational restructuring are likely to have a positive, though small effect on performance.

Since the dynamic environment within which companies operate is changing, financial managers should be ever alert to new and better ways of structuring and financing their business. The value-creation process described by Pike and Neale [1996, p. 622] involves the following:

1. Review the corporate financial structure from the shareholders’ viewpoint. Consider whether changes in capital structure, business mix or ownership would enhance value.
2. Increase efficiency and reduce the after-tax cost of capital through judicious use of borrowing.
3. Improve operating cash flows through focussing on wealth creating investment opportunities (having positive net present values), profit improvement and overhead reduction programmes and divestiture.
4. Pursue financially driven value creation using various new financing instruments and arrangements (that is, financial engineering).”

Fruhan, [1979] identified the following approaches to value enhancement: ability to command premium product prices, achievement of a reduced or lower than average
cost structure, achievement of a reduced or lower than average capital intensity, ability to obtain debt at lower than normal cost, ability to obtain equity at lower than normal cost, design of capital structure that is more efficient than that achieved by major competitors, acquiring firms via the exchange of an overvalued equity, selling overvalued equity and purchasing undervalued equities.

Successful enterprise level strategies depend on the value creation insights, which involve understanding of managers about how to improve the performance of business. According to Campbell, Goold and Alexander [1995] value creation insights are based on unique knowledge or experience of reasons why certain kinds of business have performance problems or fail to maximise their potential and ways in which managers can influence the business so as to raise performance. Value creation insights are extraordinarily diverse. Value creation insights are about major areas of improvement: raising performance, high improvement of the value of business, return on sales and sales volume. Value creation insights are linked to specific businesses that have performance opportunities and critical success factors, which the managers understand.

In line with the above arguments also, Cappelli-Konijnenberg [1995] identified five individual structures that help in value creation, that is, asset structure, capital structure, governance structure, cost structure and organisation structure. The asset structure shows the composition of the total assets the firm exploits to realise its goals. The capital structure deals with the form and relative amounts in which securities should be issued to finance investments. It refers to a mixture of long-term debt and equity the firm uses to finance its operations. Capital restructuring changes this mixture. The governance structure is the different sets of incentives; safeguards and disputes resolution processes used to control and co-ordinate the actions of various stakeholders. An ideal governance system gives managing directors enough freedom to work and make them accountable for what they did. The cost structure includes costs of operations and overheads. Changes in cost structures such as re-location of labour-intensive production to low-labour cost countries can improve the profitability of enterprises. Organisation structure such as the number of divisions in an organisation can, for example, affect the communication flow and improving this by restructuring might, therefore, create value for the firm.

Rappaport [1986] advocated for value based management to create value in a business. Copeland, Koller and Murrin [1990] also argued for transforming an entire organisation into a value maximising one using value based management (VBM). Value based management is an approach to management whereby the company’s overall aspirations, analytical techniques and management processes are all aligned to help the company to maximise its value by focusing management decision making on the key drivers of value. The authors stated that an important part of value based management is a deep understanding of what performance variables actually drive the value of the business. These variables, known as value drivers, affect the value of the company. According to Knight [1998], value is created in the operating and investment decisions that managers make on a daily basis. For value management to succeed, it has to be embedded into the company’s decision-making mind-set. This means attaining a high level of managerial understanding on how management can influence the value the company creates. It involves the translating of abstract concepts of value creation into meaningful day-to-day operating terms through the use
of operating value drivers. He argued that value management is an important issue for many companies that are faced with pressure from investors or with the need to compete more effectively.

A focus on value creation implies that decisions and actions are judged in the context of how much value they will create and that value creating behaviour is encouraged throughout the organisation. Establishing a culture driven by value creation demands a wide-reaching organisational transformation and in many cases, the most radical change is required at the top of the organisation. Monnery [1995] argues that creating value is demanding and that managers need to know exactly what they are targeting: how to measure value creation? Managers need to understand how to work towards that goal: what are the drivers of value creation? Managers also need to discover how to encourage people to do things differently.

In this decade, consulting firms are adopting new approaches of value based financial management systems to address perceived problems of the existing financial management systems. Stern & Steward and Co. [Stewart, 1991] introduced the EVA™ financial management system. EVA™ is defined as net operating profits after tax less a company’s cost of capital (including the costs of both equity and debt) subject to a number of adjustments to data reported in financial statements. EVA™ directs attention to the results created by managers and promotes that managers need to be rewarded for their achievement. Stewart [1991] argues that making managers into owners is a proven and potent way to create value. He further indicates that ownership must go beyond the merely monetary, such as pride in one’s work, sensible risk taking and above all, accepting responsibility for the success or failure of the enterprise. He advocates for value sharing: making everyone a meaningful partner in the process of adding to value. Value is created by improving operating efficiency, achieving profitable growth and rationalising and exiting unrewarding business by liquidating unproductive capital and curtailing investment in unrewarding projects.

Though it will take time to assess EVA™, recent research indicates that the novelty of the EVA™ revolution is in pointing vital linkages between financial communication, financial structure, executive incentives and the design of management and financial accounting systems [Bromwich and Walker, 1998; O’Hanlon and Peasnell, 1998; Mouritsen, 1998].

The literature reviewed indicates that financial restructuring using leveraged buyout (LBO) and management buyouts (MBO) creates value because managers have more information about the true value of the firm’s assets than outsiders and generates value by focussing on an improvement of operations. The value based management (VBM) approach indicates that management decisions and actions are judged in the context of how much value they will create.
4.4 Restructuring and Value Creation Models

In the literature of restructuring and value creation, we identified four models, which could give a relevant general framework for analysis. The models are studied in order to identify important factors for creating value that need to be empirically investigated in enterprises in transition. These models are 1. The Restructuring Pentagon of Copeland, Koller and Murrin [1990], 2. The Potential and Resilience Evaluation (PARE) model of Crum and Goldberg [1998], 3. Porter’s [1985] Value Chain Framework and 4. Rappaport’s [1986] Value Network Model.

Copeland, Koller and Murrin’s Restructuring Pentagon.

Copeland, Koller and Murrin [1990] have provided a valuation framework for calculating the value of a single or multi-business company and a restructuring pentagon framework for analysing value creation. Their valuation framework based on an analysis of the company’s free cash flow and key value drivers (see figure A4-1 in the appendices). The value of a business is the sum of the value of assets in place and the value of growth opportunities. The value of assets in place is determined by the level of net operating profit less adjusted taxes (NOPLAT), as well as the weighted average cost of capital (WACC). The value of growth opportunities is determined by the key value drivers of the rate of return on invested capital, the amount of net new investment, the period of competitive advantage, the investment rate and the weighted average cost of capital. The period of competitive advantage shows the length of time over which the expected rate of return on invested capital will exceed the company’s weighted average cost of capital. It shows the sustainability of return. The most important key value drivers in this valuation framework are the rate of return on invested capital relative to the weighted average cost of capital and the amount the company invests in new capital. Understanding the value drivers-especially the return on invested capital and the investment rate-helps to develop insight into the likely behaviour of free cash flows and value creation in the future. The return on total invested capital indicates the overall performance of the company. The return on incremental invested capital also indicates whether new capital is creating value or not.

The Copeland, Koller and Murrin [1990] model of Restructuring Pentagon (see figure A4-2 in the appendices) also shows that internal and external restructuring activities are needed to create value in a business. In the process of analysing the value of a company, first the “as is” discounted cash flow valuation is compared with the current market value of the company. Any difference between these values is a perception gap. If the market determined shareholder value is less than “as is value”, then management needs to do a better job of communicating with the analysts of the financial market so that the market value of the company might increase. A share repurchase program is also a possibility.

One way to create value is to undertake internal improvements (for example, increasing operating margins and sales growth, and decreasing working-capital requirements). By taking advantage of strategic and operating opportunities, the company can realise its potential value as a portfolio of assets. These are the myriad fine-tuning opportunities that arise from understanding the relationship between operating parameters of each business unit (key value drivers) and value creation.
Even business units that will be sold should be restructured as long as the cost of improvements is less than the extra sales premium that the improvements will bring.

Another way of creating value is determining the value enhancement potential that arises from external opportunities, that is, shrinking the company via sell-offs, expanding it through acquisitions or both. Some business units, even though fine-tuned, can be more valuable in alternative uses, and should be sold. The motivation for divestiture is usually straightforward; another company can better manage the assets. Consequently, the buyer is willing to pay a higher price than the current value of the company to the owners. Divestiture can enhance value to the seller which can then redeploy the cash received to improve its own core business. Unrelated businesses are particularly good candidates for sell-offs. In acquisitions, combinations that provide real synergies can enhance value. In other instances, if companies cannot be made profitable (by any one) then they should be shut down.

In our study, the Copeland, Koller and Murrin [1990] models are used in designing a conceptual framework and in identifying the key value drivers to measure whether value is created or lost in the Eritrean manufacturing enterprises. Moreover, the concept of internal and external restructuring requirement to create value is essential for understanding the functioning of the enterprises in transition.

**Crum and Goldberg’s Potential and Resilience Evaluation (PARE) Model**

Crum and Goldberg [1998] developed a framework for the assessment of enterprise viability known as Potential and Resilience Evaluation (PARE). The authors argued that taking actions that increase the potential and the resilience of a company create value. They also view that PARE can be used to assess companies in transition to a market economy.

**Potential**, according to Crum and Goldberg, refers to the company’s ability to generate cash flows. High returns come when managers allocate the resources of the firm to investments that generate net increases in net assets that exceed the minimum level necessary to compensate investors for risk. The potential of a company depends on the innovation ability and the implementation capacity of the firm.

**Innovation ability** of the company depends on the management’s ability to find and nurture profitable investment opportunities in the future. Management must be able not only to create a sufficient number of new projects over time, but also to abandon existing projects when they no longer yield higher returns and rechannel their resources to more profitable uses. Some of the measures used in measuring innovation ability are earning power, cash flow margin, profitability index, sales growth, market share growth, R & D expenditures as a percent of sales and average number of patents generated per year.

**Implementation capacity** refers to the company’s management skill and resources to implement projects successfully. The degree of implementation capability of a company depends on the extent that the resources are available at the time needed, at the location required and in the form demanded. The factors that indicate implementation capability of a company are subjective and not amenable to quantification. Some of these measures are general management knowledge and skill,
specific marketing knowledge and skill, knowledge of product qualities and skill, technology familiarity and sophistication and funding capacity for new investments.

The assessment of innovation ability and implementation capacity indicates the preferred position is strength in both innovation ability and implementation capacity. If the position of the company is strong in one of the dimensions and weak in the other, corrective actions need to be focussed on in the problem area. PARE refines the suggestion for remedial action to focus more explicitly on identified problems. If a firm is weak in both innovation ability and implementation capacity, serious consideration might be given to liquidation. They have no chance of succeeding in the long run without major investment and restructuring. Management then needs to assess the company’s resilience before deciding to liquidate a company.

Resilience refers to the risk associated with the future cash flows. It is used as a surrogate concept of risk. Risk can be viewed as the likelihood that the firm will not develop over time in accordance with what investors perceive to be its strategic targets. Hostile forces may erode the firm’s competitive position and perhaps even threat its continued existence. Two strategically significant dimensions of risk focus on different aspects of this possible erosion: the vulnerability position and the reserve capacity of the firm.

The vulnerability position of the firm refers to the extent to which hostile forces are perceived to exist in the company’s operating environment that could cause significant disruption in profitable operations. This is the “threat” dimension and it is a major aspect of risk. What is assessed is what could go wrong and the concern is with conceivable threats that would hurt the company if they come into play. Some useful indicators of vulnerability are cash flow concentration by products, sales concentration by products, debt maturity structure, fixed charge coverage, operating leverage (percentage change in earnings before interest and taxes), pace of technology change, cash flow variability and sales variability.

Reserve capacity refers to the ability of the company to defend adversity, to marshal resources quickly to avoid extremely detrimental consequences of disruptive events, and to survive essentially intact when subjected to disintegrative forces. Some useful indicators of company’s reserve capacity are liquidity, cash flow coverage, fungible assets, decrease in costs if workers are laid off, impact of production shutdowns on cash requirements and cancellation costs from project abandonment.

The resilience position of a company is assessed using the combination of the threat side—the vulnerability position and the defensive side—the reserve capacity. By assessing the vulnerability and the reserve capacity, management knows the primary source of difficulties—lack of reserve or too much vulnerability or both—as well as any strengths—sufficient reserves or low vulnerability. Risk is a negative dimension and companies want to avoid it to the extent that is prudent.

The overall evaluation of the firm is done by assessing, the potential and resilience dimensions. Strong potential and strong resilience, according to Crum and Goldberg [1998], shows that the company is strong competitor and vigilance is required to maintain that position. On the other hand, low resilience and low potential shows that the management should consider liquidation or, at a minimum, severe restructuring.
Evaluation of a company in terms of its potential and resilience helps in identifying problems and indicates corrections needed to create value.

According to Crum and Goldberg (1998), PARE’s market focus and its orientation towards what is required to improve competitiveness fit the situation in the countries undergoing transition to a market economy. It helps managers to ask the right questions, to identify the proper priorities and to determine appropriate actions.

In our study, the Crum and Goldberg [1998] model is used to identify variables and their measures in designing the conceptual framework of this study. Moreover, it helps in understanding the actions needed to improve the potential and the resilience of the companies studied. It highlights important issues to be studied such as management ability and skills in creating value and it helps to identify primary sources of difficulties and corrections needed to find and nurture value creation opportunities.

**Porter’s Value Chain Model**

According to Porter, [1985], the profitability of a firm is influenced by its industry structure and by the strategic choice it makes in positioning itself in the industry. The first fundamental determinant of a firm’s profitability is industry attractiveness. In any industry the rules of competition are embodied in five competitive forces: the entry of new competitors, the threat of substitutes, the bargaining power of buyers, the bargaining power of suppliers and the rivalry among the existing competitors. These five forces determine industry profitability because they influence the prices, costs and required investment of firms in an industry.

The second basic determinant of a firm’s profitability is its relative position within its industry. Positioning determines whether a firm’s profitability is above or below the industry average. A firm that can position itself well may earn high rates of return even though industry structure is unfavourable and the average profitability is therefore modest. The fundamental basis of above average performance in the long run is sustainable competitive advantage.

Competitive advantage grows fundamentally if a firm is able to create value for its buyers that exceed the firm’s cost of creating it. Superior value stems from offering lower, but more profitable, prices than competitors for equivalent benefits or providing unique benefits that more than offset a higher price. There are two basic types of competitive advantages: cost leadership and differentiation.

The Porter’s *value chain approach* describes a fundamental role of the value chain in identifying sources of *cost* leadership and *differentiation*. The value chain is an approach that views the firm as being a collection of discrete but related activities. The term *value chain* means all the activities that add value, starting with product design, continuing with the procurement of resources, then with the steps in the production process, and concluding with the movement of the product from the factory to the customer. The objective of value chain analysis is to move materials from vendors, through production, and to the customer at the lowest cost and in the shortest time. The value chain formulation focuses on how these activities create value and what determines their cost, giving the firm considerable latitude in
determining how activities are combined. Every firm is viewed as a collection of activities that are performed to design, produce, market, deliver and support its products (see figure A4-3 in the appendices). Value activities are divided into two broad categories, primary activities and support activities.

Primary activities are the activities involved in the physical creation of the product and its sale and transfer to the buyer as well as after-sale assistance. Primary activities include, inbound logistics (receiving, storing, material handling, inventory control and others), operations (activities associated with transforming inputs into final product, for instance, transforming cotton into cloth needs blowing, spinning, weaving and finishing), outbound logistics (storing and distribution to buyers), marketing and sales (advertising, promotion, sales force, quoting, channel selection, channel relations, and pricing), and service (installation, repairs, training, parts supply, and product adjustment).

Support activities include procurement (the function of purchasing inputs used in the firm’s value chain), technology development (activities directed to improve products and processes), human resources management (recruiting, hiring, training development and compensation of all types of personnel), and firm infrastructure (general management, planning, finance, accounting and others).

A firm’s value chain is embedded in a larger stream of activities, that is, the value system (see figure A4-4 in the appendices). The value system includes suppliers’ value chains, the firm’s value chain, channel value chains and the buyers value chains. Suppliers have value chains that create and deliver the purchased inputs used in a firm’s chain. For instance, cotton farmers value chain will affect the input cost of a textile company. Linkages between suppliers’ value chains and a firm’s value chain provide opportunities for the firm to create value. In addition, many products pass through the value chain of channels (channel value) on their way to the buyer and these influence the firm’s own activities. Channels perform such activities as sales, advertising and display that may substitute for or complement the firm’s activities. The channel mark-up over a firm’s selling price (channel value) often represents a large proportion of the selling price to the end user. Thus as with suppliers’ linkages, co-ordinating and jointly optimising with the channels can lower cost or enhance differentiation.

Porter’s value chain approach provides a systematic way of understanding the behaviour of costs and revenues and the existing and potential sources of differentiation. With cost leadership, a firm sets out to become the low-cost producer in its industry. The firm has a broad scope and serves many industries’ segments, and may even operate in related industries. The firm’s breadth is often important to its cost advantage. The sources of cost advantage include the pursuit of economies of scale, proprietary technology, preferential access to raw materials and others. Cost advantage results if a firm achieves a lower cumulative cost of performing value activities than its competitors. The strategic value of cost advantage hinges on its sustainability. Sustainability will be present if the sources of a firm’s cost advantage are difficult for competitors to replicate or imitate. Cost advantage leads to superior performance if the firm provides an acceptable level of value to the buyer so that its cost advantage is not nullified by the need to charge a lower price than competitors.
In a differentiation strategy, a firm seeks to be unique in its industry along some dimensions that are widely valued by buyers. It selects one or more attributes that many buyers in an industry perceive as important and then uniquely positions itself to meet those needs. It is rewarded for its uniqueness with a premium price. Differentiation can be based on the product itself, the delivery system by which it is sold, the marketing approach, and a broad range of other factors. A firm must truly be unique at something or be perceived as unique if it is to expect a premium price. Differentiation derives fundamentally from creating value for the buyer through a firm’s impact on the buyer’s value chain.

In our study, we used the Porter’s [1985] Value Chain Model in designing the framework of this study and restructuring activities questionnaires. The concept of backward and forward linkages with suppliers and buyers respectively is incorporated in our framework. Moreover, we used the concept of value chain analysis (all activities that add value) in designing restructuring activities questionnaires to identify what activities do managers perceive as value creating restructuring activities.

Summarising we find that industry attractiveness and competitive advantage are principal sources of value creation. The more favourable these are, the more likely the company will create value.

Rappaport’s Value Network Model.

Rappaport [1986, p.76], provided a framework analysis for value creation, that is indicated by him as a “shareholder value network” (see figure A4.5 in the appendix). Value creation addresses the change in value over a period. Rappaport [1986] Value Creation Network Model is helpful in answering the third research sub-question of this study because it shows the determinants of value. It also provides measures of performance which are needed for answering the fourth research sub-question of this study, have companies been creating value during 1991-1997, to what extent and how? In addition, this model provides a framework for value creation by restructuring operations, investment, and financing, which are the kinds of restructuring that are addressed in the fifth research sub-question of this study. The Rappaport model was also used in acquisitions in the western market economies and thus may also be helpful in understanding privatisation acquisitions.

The “shareholder value approach” estimates the economic value of an investment by discounting forecasted cash flows by the cost of capital. The total economic value of an entity such as a company or business unit is the sum of the value of its debt and its equity. The shareholder value is the difference of the value of the total firm and the market value of debt. The total value of the firm consists of three components, that is, the present value of cash flow from operations during the forecast period, “residual value” which represents the present value of the business attributable to the period beyond the forecast period and the current value of marketable securities and other investments that can be converted to cash.

Cash flow from operations represents the difference between operating cash inflows and cash out flows. These cash flows are relevant for estimating the firm value because they represent the cash available to compensate creditors and owners.
The cash flows are discounted to their present value using the weighted average cost of debt and equity capital.

The shareholder value network depicts the essential link between the corporate objective of creating shareholder value and the basic valuation parameters or value drivers: sales growth rate, operating profit margin, income tax rate, working capital investments, fixed capital investment, cost of capital, and value growth duration.

*Sales growth* is the percentage increment of sales expected in a period. It shows the market growth potential of a company. Normally the higher the sales growth, the higher the value of the company.

*Operating profit margin* is the ratio of pre-interest, pre-tax operating profit to sales. The net profit is calculated by deducting cost of goods sold, selling and administrative expenses from sales.

*Fixed capital investment* is the money invested in acquiring long term assets such as building, equipment, land and other long-term investments. Capital expenditures include expenditures on new (and replacement of) property, plant and equipment. The incremental fixed capital investment is defined as capital expenditures in excess of depreciation expense.

*Working capital investment* represents the net investment in accounts receivable, inventory, accounts payable, and accruals that are required to support sales growth. Increases in working capital requirements reduce the value of a company.

The *corporate income tax rate* represents taxes on operating profit for a period (e.g. a fiscal year) that are either paid by instalments during the year or are a liability at the end of the year. It is the amount of tax attributable to the operating profit. It does not include taxes on interest income and other non-operating income items.

*Cost of capital*: The appropriate rate for discounting the company’s cash flow stream is the weighted average cost of debt and equity capital. Estimating the cost of capital is essential for establishing the minimum acceptable rate of return or hurdle rate that management should require on new investment proposals. Investments yielding returns greater than the cost of capital will create shareholder value, while those yielding less than the cost of capital will decrease shareholder value. The relevant weight of debt and equity is based on the proportion that the firm targets for its capital structure over the long-term planning period. The relevant rate for the cost of debt is the long-term rate or yield to maturity which reflects the rate currently demanded by debt holders. The relevant rate for the cost of equity is an implicit rate of return required to attract investors to purchase the firm’s stock and to keep it. The cost of equity is the sum of the risk free rate and the equity risk premium. The rate on long-term treasury bonds serves as the best estimate of the risk-free rate. The equity risk premium is the difference of the expected return on the market portfolio and the risk free rate multiplied by the company beta. The risk premium represents additional compensation that investors expect for holding stocks rather than “risk–free” government bonds.
The final value driver, *value growth duration*, is management’s best estimate of the number of years that investment can be expected to yield rates of return greater than the cost of capital.

The shareholder value network shows the link between management decisions and value drivers. Operating decisions such as product mix, pricing, promotion, advertising, distribution, and consumer service level are impounded primarily in three value drivers: sales growth rate, operating profit margin, and income tax rate. Investment decisions such as, increasing inventory levels and capacity expansion are reflected in the two investment value drivers: working capital and fixed capital investments. The cost of capital value driver is governed not only by business risk but also by management’s financing decisions, that is, the question of the proper proportions of debt and equity.

In our study, we used Rappaport [1986] Value Creation Network Model as a primary model in designing our conceptual framework. The concept of management decisions on operations, investments and financing influence the value created in an enterprise is incorporated in our framework. Moreover, it helped us to identify the value drivers and to measure the value performance of companies studied. The model was also helpful in structuring and analysing the empirical data collected.

The value creation models generally aim at creating value for owners. Some researchers, however, argue that value creation has to focus on stakeholders rather than shareholders [Freeman, 1998]. Stakeholders include employees, managers, customers, suppliers, and government and extend to any one who benefits from the company. However, determining the aims, benefits and value generators for each stakeholder is difficult. Copeland, Koller and Murrin [1990] argue that focusing on shareholder value does not ignore the other stakeholders. If the company ignores to assess the interests of its employees, for example, the employees will leave. Due to this, managers have to integrate the interests of the stakeholders of a company in attempting to create value.

In our study, we have used the value creation models as a framework to identify the variables that need to be studied in increasing the value of companies. The aim is to apply the concepts of operations, investments and financing and their measures to the issue of restructuring companies for higher values. It also helps to more sharply focus management’s attention on lines of activity it can competently manage to create value. Therefore, when the term value creation is used in this study in connection with the financial data it means the excess of the return on total capital (ROTC) over the cost of capital (k) as used in the Rappaport [1986] and Stern Stewart and Co. [1991]. However, when the term value creation is used in connection with value adding general management activities as discussed in the Porter [1985] Value Chain model, it shows value enhancing restructuring activities in operations, investments, financing and governance.
4.5 Corporate Restructuring and Value Creation in Transition Economies

In order to study the experiences of restructuring enterprises in transition, we reviewed the literature of the Central and Eastern European countries. In the literature, researchers have found that there is a need of restructuring enterprises pre and post privatisation. Johnson, Kotchen and Loveman [1996] claim that there is a need for an integrated restructuring plan that aligns changes in business strategy, enterprises finances and investment, control systems, marketing, operations and human resources. Simply letting the loss-making, insolvent enterprises collapse (in the hope that their assets, which in any case are highly specific, will be taken over by other healthier enterprises, or preferably, multinationals) proved to be misconceived and politically at least, too costly an option because doing so would have resulted in the collapse of practically the whole domestic industry.

Major [1993] argues that governments frequently emphasise their intention to upgrade and restructure the state-owned companies first and to sell them later. The governments’ chief argument is that in several cases, enterprises to be sold have vast potential, that is, not reflected in the initial offer prices, and in order to obtain a much higher price for these companies, they must be modernised. There may be cases, according to Major, where such an argument is relevant. For instance, if an enterprise is not attractive enough to private investors because it carried old debts or it has some units, which are liabilities rather than assets and which can be detached easily, then an initial restructuring can improve the seller’s bargaining position considerably.

During privatisation, it might thus be important to devise policies to improve the performance of viable but at present loss-making and non-competitive enterprises that remain (for the time being) under effective control of the government. This raises important issues, of how to increase their autonomy and their profit orientation. If the enterprise potential value could be enhanced, restructuring could involve refinancing of debt, reorganising operations to reduce or eliminate unprofitable activities, slimming down the payroll or bringing in new management [UNCTAD, 1993].

Filatotchev [1996] argues that changes in operations, financing and governance are essential elements of restructuring during the transition. Operating changes relate to growth and diversification, training and recruitment and relationship with stakeholders, such as trading partners. Financial issues include changes in working capital, investment, wages and source of finance for investments. Governance relates to ownership and control exerted by owners, managers and employees and others.

Operational restructuring denotes changes in the existing production mix, introduction of new products, improving distribution channels, reducing labour and material costs and reorienting production towards customer demanded goods to increase the profitability of the company.

The experience of the Central and Eastern European countries reveals that most of the enterprises engaged in labour reduction to compete in the market environment and reduced outputs to adjust to the new market environment prior to privatisation. The liberalisation of prices and trade increased the prices of materials and energy and decreased the demand for domestic goods due to import competition. The decrease in customers’ demand for domestic goods resulted in low capacity utilisation by the
firms. Managers encountering a severe sales problem tried to find a way out by conducting an active sales policy, changing the mix and profile of output towards more sellable products, diversifying production and reducing of production costs [Estrin & Gelb, 1995; Dolgopyatova & Evseyeva, 1995]. According to Belka et al. [1993], one of the key factors of enterprise adjustment during transition is the speed and efficiency of the company’s efforts to restore its domestic distribution network. Those who succeed are able to fend off foreign competition and even expand. Those who neglected it in the first stage of transition faced the formidable task of recovering due to a difficult and expensive market with new or improved products and a lack of adequate marketing and sales specialists. However, the experience of transition economies shows that only a few managers engaged in the introduction of new products, the development of new processes and the development of new markets prior to privatisation.

**Investment restructuring** denotes the changes in fixed capital and in working capital investment of a business. Enterprises in the transition economies are using old machinery, which hampers competition with the imported products from the developed economies. The machinery is often purchased at the time of establishment of the company and replacement may be neglected due to the fact that managers were more concerned with employees’ welfare. Since modernisation of the machinery might reduce the labour force, they have been using outdated machinery. This practice hampered modernisation and technology advancement of factories and when the market was liberalised after the fall of communism in Central and Eastern Europe, the enterprises faced difficulties in competing in the market. According to Belka et al. [1993] the fixed assets are worn out, with depreciation rates of 60-70%, and the process of decapitalisation is steadily accelerating. Most modernisation projects undertaken aim at the reduction of cost (energy saving, smaller consumption of materials, lower input of labour). Very few fixed asset investment projects undertaken actually enlarge the production capacities of the firms. The main cause of low investment was the lack of financial resources. The decline in profitability of the state-owned enterprises each year decreased the financial reserves of the companies. Besides, according to Belka et al. [1993, p. 39], “the low investment in fixed assets was due to the high risk of investment decision because of lack of clear ownership prospects of an enterprise and clear management stance, due to the drop in consumer demand resulting from much lower purchasing power and due to the absence of an essential financial infrastructure (an efficient banking system and a capital market).” As demonstrated by Dixit [1989] uncertainty can have a powerful negative effect on the incentive to move promptly to take advantage of investment opportunities. Indeed, when the environment is uncertain, potential entrepreneurs have a strong incentive to delay even attractive projects, if part of the investment is irreversible.

**Financial restructuring** during privatisation includes [Rideley, 1996; Saez, 1996], elimination or reduction of old debts to the government to make companies attractive to buyers, injecting capital for new investments, debt to equity swaps in which the creditors of an enterprise agree to accept ownership shares once the enterprise becomes a corporation, refinancing external debt, debt relief such as debt restructuring at reduced interest rates and with longer maturities and partial debt write-downs, sale of assets, equity issues simultaneous with the privatisation of existing stock and transfer of part of the sales proceeds to the company itself.
The experience of Central and Eastern European countries reveals that the governments generally stopped direct subsidies to pressure companies to become self-financing and gave managers autonomy to govern enterprises. However, as Kornai [1990] predicted the managers of loss making enterprises were often able to soften the budget constraints because the politicians were not ready to liquidate loss-making enterprises due to the social consequences and they have been guaranteeing bank loans to these companies. Kornai [1980] explained that an enterprise has soft budget constraints when it expects to be bailed out in case of financial trouble. This creates an incentive problem because the manager of the organisation will fail to observe financial discipline. The state-owned banks also have been approving loans to loss-making companies without rigorous analysis because if the companies become bankrupt they will lose the money that they had already loaned to these companies. Hoping that the financial condition will improve, the banks kept funding non-viable enterprises. In addition, when the government direct subsidy was hardened, managers of loss making companies resorted to inter-enterprise loans, borrowing from other state-owned enterprises. This led to bad debt accumulation in the enterprises and banks.

The accumulation of debts deterred the buyers of enterprises at the time of privatisation and in order to attract investors, the governments of the Central and Eastern European countries tried to clean the balance sheets of the enterprises to make the companies sellable. Though all governments tried to tackle this problem by absorbing the enterprises’ debts, their approach differed. Some countries directly wrote-off enterprises’ debts while others segregated financially troubled enterprises or transferred the responsibility of enterprise debt restructuring to banks.

The experience of Hungary and Bulgaria, for instance, revealed that the government wrote-off enterprises’ debts to alleviate the financial problem that the companies had been facing. This relieved enterprises from interest payments. However, the debt write-off should be done only once. Otherwise, it gives an indication to the management that the government will bail-out the companies in case of financial problem and thus may tempt them to undertake projects that destroy company value. According to Dobrinsky [1996, p.393], “the governments of Hungary and Bulgaria wrote-off companies’ debts several rounds during 1992-1994.” This may have been reducing the credibility of hardening of budget constraints.

Some governments (such as Poland and Romania) also isolated financially troubled enterprises (‘hospitalisation’) and tried to restructure them to make them viable. The governments provided finances, set up a restructuring agency and asked managers to turn around their companies in two to four years. Enterprises, which did not improve after the isolation program, were liquidated. These programs were not very successful because the managers were appointed by workers and thus, were not able to lay-off redundant workers. Djankov [1998] studied the enterprise isolation program of Romania. According to Djankov, the isolation program did not deliver any tangible improvements in operational performance, nor did it enhance the process of privatisation or liquidation of large loss-making enterprises. The main reasons cited for the failure of the Romanian isolation programs are management’s reluctance to undertake measures unpopular with workers and a lack of managerial skills. Managers were unable to assess their firm’s financial status because no attention was paid to such details in their previous work. Wijnbergen [1996] also argues that isolating
financially troubled enterprises destroys value because their managers can successfully bargain for subsidy instead of adjusting to the free market and the stigmatisation as sick enterprises makes it difficult to regain access to banking loans, even after they have been restructured. Wijnbergen, therefore, recommends the involvement of commercial banks in restructuring financially troubled enterprises in transition.

Many governments in Central and Eastern Europe assigned the responsibility of restructuring enterprises to banks. They were assigned the following tasks: to identify viable, viable with debt relief and non-viable enterprises; to work with management of over-indebted firms on a restructuring plans before granting a debt relief; to liquidate non-viable firms; to fund new investments needed for physical restructuring; and to provide corporate governance through representation on the board of directors. In Poland the government instead of directly restructuring financially troubled companies, assigned banks to work out a restructuring plan with their clients (state-owned enterprises). The banks had formal and informal options for restructuring enterprises with a debt problem (see figure 4-1).

Figure 4-1 Approaches to Bank-led Enterprise Restructuring.

Source: [Montes-Negret and Papi, 1997, p. 3]
In Poland, banks helped in enterprise restructuring. The bank managers tried to solve the enterprise debt problem with informal means. They transferred the debt to a government agency in exchange for government security or to an internal workout unit of the same bank staffed with qualified analysts who helped the enterprises to restructure. In addition the banks also used debt-for-debt swaps. The revised loan contract can involve some debt rescheduling, interest rate reduction, new collateral requirement and an agreement on a restructuring plan. The bank can also take an equity stake instead of its loan, reducing the seniority of its claim, but increasing its control rights over the enterprise [Montes-Negret and Papi, 1997]. According to Montes-Negret and Papi (1997), the Polish program of bank led enterprise restructuring had a positive influence on the enterprise sector because the situation of distressed enterprises improved and the number of firms facing financial troubles dropped. According to Montes-Negret and Papi’s study, the Polish restructuring program aimed at improving the financial condition of enterprises and promoting implementation of internal changes within these enterprises. These programs provided management with a complete diagnosis of the enterprise condition, and allowed management to work with experienced analysts and advisors. This practice helped managers to learn how to conduct analytical studies and to prepare recovery programs that included forecasts of sales and cost, restructuring plans, the establishment of sales and marketing units, and the implementation of new production methods and techniques.

The literature on restructuring of enterprises in Central and Eastern Europe indicates that companies require operational, investment and financial restructuring to adjust to the new market environment and to create value. Table A4-1 summarises relevant articles on privatisation and restructuring that help in identifying the restructuring needs of enterprises in transition and the measures used to identify performance. The governments emphasised mainly financial restructuring because debt accumulation in enterprises deterred buyers. The bank led enterprise restructuring in Poland had some positive influence, while the isolation (‘hospitalisation’) of enterprises was less successful. In addition, the managers reduced labour and output to adjust their operations to the market environment, but they did not introduce new products or production systems to enhance their operations. Moreover, the managers hardly restructured assets due to the uncertainty of the environment and those few investments done were related to cost reduction rather than to capacity expansion.

The case studies of enterprises in transition studied by consultants, international agencies such as World Bank and United Nations Development Organisation (UNIDO) and other researchers reveal how enterprises can be restructured for successful privatisation. The success and failures of enterprises to restructure may provide a lesson for Eritrea. Appendix A4-2 summarises case studies of some companies in the Central and Eastern European countries [Estrin et al., 1995; Johnson, Kotchen and Loveman, 1995 and Martin, 1996].

The case studies indicate that companies which narrowed their product focus and reduced their product cycle were able to restructure and attract investors. Moreover, market oriented managers played a key role in restructuring their companies. In addition, low labour cost in the Central and Eastern Europe in comparison with the Western Europe gave a competitive advantage to the enterprises in these countries.
The geographical proximity of the Central and Eastern Europe countries to the market in the Western Europe helped the companies to improve their financial condition. The successful companies also upgraded their technology and modernised their machinery to produce quality and competitive products. The successful companies subcontracted work to West European companies, in particular in textiles clothing, to take advantage of the low labour cost. The acquaintance with foreign subcontractors has helped in eventual privatisation of the companies. The companies’ distribution channels also changed from wholesale and retail chains to direct sales to final customers.

The case studies also show companies which failed to adapt to the new market environment and which have problems in getting investors. In these companies, the management showed little will to implement reform and they were mainly production oriented. These managers tried to lobby for subsidy rather than to engage in restructuring their companies. However, the government cut subsidies and the companies’ debt increased. The creditors also demanded payment. The worsening financial condition of the companies was becoming a constraint not only for attracting investors but also for getting qualified managing directors as well.

In their study of Russian enterprises, Earle, Estrin and Leshchenko [1996] identified restructuring activities (production, employment, investment and marketing) that enhance enterprise value and used managers’ own views in evaluating the restructuring activities needed. They invited managers to indicate their priorities across a variety of activities in each area. They asked managers to respond on a scale of 1 (not important) to 3 (very important) for each activity. Table 4-1 shows the restructuring areas and specific activities within each area.

<table>
<thead>
<tr>
<th>No.</th>
<th>Production strategy</th>
<th>Employment strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Change in area of activity</td>
<td>Decrease in labour</td>
</tr>
<tr>
<td>2</td>
<td>Changing production mix</td>
<td>Increase in labour</td>
</tr>
<tr>
<td>3</td>
<td>Change of inventory policy</td>
<td>Cutting social benefits</td>
</tr>
<tr>
<td>4</td>
<td>Closing of plant/shop</td>
<td>Cutting wages</td>
</tr>
<tr>
<td>5</td>
<td>Change in product quality</td>
<td>Increasing wages</td>
</tr>
<tr>
<td>6</td>
<td>Disposing of assets</td>
<td>Increasing wage differentials</td>
</tr>
<tr>
<td>7</td>
<td>More efficient use of resources</td>
<td>Modify or establish an internal wage scale</td>
</tr>
<tr>
<td>8</td>
<td>Changing technology</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Seeking foreign consulting advice</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>New investments</td>
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</tbody>
</table>

**Investment strategy**

<table>
<thead>
<tr>
<th>No.</th>
<th>Investment strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Reducing new bank borrowing</td>
</tr>
<tr>
<td>2</td>
<td>Reschedule loans</td>
</tr>
<tr>
<td>3</td>
<td>Obtain new loans from banks</td>
</tr>
<tr>
<td>4</td>
<td>Obtain new loans from non-banks</td>
</tr>
<tr>
<td>5</td>
<td>Lengthening period of payables</td>
</tr>
<tr>
<td>6</td>
<td>Reducing outstanding receivables</td>
</tr>
<tr>
<td>7</td>
<td>Change of bank connections</td>
</tr>
<tr>
<td>8</td>
<td>Seeking foreign investors</td>
</tr>
</tbody>
</table>

**Marketing strategy**

<table>
<thead>
<tr>
<th>No.</th>
<th>Marketing strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Improve marketing</td>
</tr>
<tr>
<td>2</td>
<td>Change distribution network</td>
</tr>
<tr>
<td>3</td>
<td>Change suppliers</td>
</tr>
<tr>
<td>4</td>
<td>Seeking new domestic markets</td>
</tr>
<tr>
<td>5</td>
<td>Increasing export efforts</td>
</tr>
<tr>
<td>6</td>
<td>Increase product price relative to competitors</td>
</tr>
<tr>
<td>7</td>
<td>Drop product price relative to competitors</td>
</tr>
</tbody>
</table>

Source; Earle, Estrin and Leshchenko [1996, p. 235]
The authors used these activities to test their hypothesis that difference in ownership will result in different restructuring actions by managers. However, the responses of the managers showed that there was little variation in the restructuring measures in the different ownership types tested (state-owned, employee-owned, management-owned, outsider-owned and newly established firms). The managers’ responses, however, showed that the managers regard marketing and investment/finance activities as slightly more important than production or employment related restructuring activities, regardless of ownership category. The Russian managers consider increasing the efficiency of input and investment very important, while disposing off of assets, seeking foreign consultants and closing plants or shops of low importance. On the marketing side, managers of all ownership categories rate an improvement in marketing and discovering new domestic markets very highly, but place less emphasis on price adjustments or changing suppliers.

Gurkov [1997] studied Russian enterprises’ adaptation to new economic realities to generate insights into the restructuring of the business and identified from the literature problems that the enterprises in transition are facing. He conducted a survey of managers and he asked them to identify the problems that their companies are facing using a 5-point scale ranging from ‘not important at all’ to ‘extremely important’. Non-paying debtors, lack of the means to purchase raw materials and semi-finished goods, high debts to banks and suppliers and irregularity of production were listed as the most disturbing factors in 1994. Table 4-2 shows a ranked order of problems identified by the managers.

Table 4-2 Shows Ranked Order of Managers’ Assessment of the Importance of the Problems

<table>
<thead>
<tr>
<th>No.</th>
<th>Problems</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Non paying debtors</td>
</tr>
<tr>
<td>2</td>
<td>Disturbances in supply of raw materials</td>
</tr>
<tr>
<td>3</td>
<td>High bank debts and trade liabilities</td>
</tr>
<tr>
<td>4</td>
<td>Irregularities of production operations</td>
</tr>
<tr>
<td>5</td>
<td>Absence of orders, contracts</td>
</tr>
<tr>
<td>6</td>
<td>Irregularity in energy and fuel supply</td>
</tr>
<tr>
<td>7</td>
<td>Poor work discipline</td>
</tr>
<tr>
<td>8</td>
<td>Staffing by managers</td>
</tr>
<tr>
<td>9</td>
<td>Staffing by qualified workers</td>
</tr>
<tr>
<td>10</td>
<td>Delay in wage payment</td>
</tr>
<tr>
<td>11</td>
<td>Languror of the company’s top management</td>
</tr>
<tr>
<td>12</td>
<td>Danger of unemployment</td>
</tr>
</tbody>
</table>

Source: Gurkov [1997, p.63]

The restructuring activities identified by Earle, Estrin and Leshchenko [1996] and the problems identified by Gurkov [1997] are used in designing questionnaires in the empirical part of our study. We asked managers in Eritrea to assess the importance of these activities in creating value in their enterprises.
4.6 When to Restructure Enterprises in Transition

One of the issues debated in the transition economies is when enterprises should be restructured. There are three possibilities of sequencing privatisation and restructuring enterprises during transition. These possibilities are:

1) Privatise the state-owned enterprises first without any attempt to restructuring the company “as is” and let the new private owners decide how to restructure the operations to create value.

2) Fully restructure the state-owned enterprise first then privatise it.

3) Partly restructure the state-owned enterprises before privatisation and let the new owner decide how best to complete the task.

Privatisation without restructuring usually results in a low price for the enterprises. But restructuring to gain a better purchase price is costly and difficult. Lack of clarity about who has, and will have ownership rights vis-à-vis enterprises results in tremendous uncertainty about the future of incumbent managers and management bodies (such as enterprises and workers councils). This prompts a wait-and-see attitude, which does not stimulate structural change. The resolution of this uncertainty is critical for eliciting the much needed supply response through restructuring during the transition [Sood, 1991]. Most of the factors that caused the poor performance in the first place remain. It is difficult to motivate management and staff to improve performance if their jobs will be at risk from privatisation. Restructuring measures pursued before privatisation may also differ markedly from the direction intended by subsequent buyers.

Kornai [1990] argues that state-owned enterprises will be too arthritic and bureaucratic to respond to the opportunities opened up by the move to a market system and a free trade. The inference is that with the possible exception of state-owned firms purchased by foreign companies, industry level supply responses will rely disproportionately on the growth of the new private sector, including perhaps their gradual absorption through a bankruptcy procedures of the assets of the old state sector. Kornai [1990], Lipton and Sachs [1990], Aslund [1991] and Blanchard et al [1991] place efficiency in the centre of discussion of privatisation. They argue that only responsible private owners can be expected to utilise resources efficiently, while public or state ownership usually resulted in careless spending by the company managers in wasteful resource allocation and in a lack of the company’s flexibility.

However, the findings by Pinto et al. [1993] showing signs of restructuring among state-owned enterprises in Poland and a parallel study by Estrin, Gelb and Singh [1993] provide evidence against the Kornai hypothesis. State-owned enterprises in the Central and Eastern European countries made major adjustments in the light of their new circumstances and these responses, which are not solely sponsored by foreign participants, appear to contain the bulk of industry level adjustment. To survive in the new business environment, enterprises must reorganise, downsize their operations, shed excess labour, sell their non productive assets, improve the quality of their products, and find new markets. Some state-owned enterprises may be viable, but not without labour shedding and the infusion of new, more modern capital. Unless restructured, potentially viable enterprises usually fail to attract a buyer [Carlin, 1993]. The adjustment responses of enterprises to the reform depend on the firm’s financial situation and the motivation and capability of the management [Estrin, et.
al., 1995]. The question is how much the government should do to help resolve these underlying structural difficulties. Some studies [Ernst, Alexeev and Marer, 1996] argue for government intervention while others [Kornai, 1990] oppose government intervention during the transition period. Government restructuring measures such as hardening budget constraints, financing of severance payments, and selective debt write-offs affect the distribution of gainers and losers and may be used to overcome blocking coalitions and increase support for restructuring [Aghion, Blanchard and Burgess, 1994]. Aghion, Blanchard and Burgess [1994] also argue that enterprise managers with good career prospects after privatisation will have incentives to restructure in order to enhance the balance sheets of their companies.

Ernst, Alexeev and Marer [1996] argue that the state has a legitimate role in assisting privatisation and fostering improved efficiency by helping to restructure firms. Debt reduction on a large scale is often necessary. In addition, large firms that are losing money and can find no private buyer must be restructured with government help, either for eventual privatisation or simply to keep them from continuing to be a drain on the budget. According to Ernst, Alexeev and Marer, large government restructuring programs should be undertaken mainly to deal with problems, which the private sector cannot or will not deal with, as early steps in the transition.

Policy has been focused, according to UNECE [1993], too much on the divestment of large state firms, while the possibilities for improving their performance were not sufficiently explored. Systemic change in itself has already reduced or eliminated many growth retarding factors: the priority treatment of the military sector and the ideological commitments to full employment. After removal of these impediments, state-owned companies may have a good chance to improve their performance relative to the past [UNECE, 1993].

After a decade of transition experience in Central and Eastern Europe, researchers indicate that enterprises require pre-and post-privatisation restructuring. In the pre-privatisation, the government should restructure companies by shedding labour, preferring some financial restructuring, such as debt reduction and by introducing hard budget constraints to make companies autonomous and profitable. However, the new owner, who has the ability and entrepreneurial drive to commit funds and run the business on a market oriented basis, should make major investments in equipment, modernising technology, developing new products and by large investments in research and development.
4.7 Conclusions

Value based management system helps managers to focus on activities that create value. The value based financial management system also emphasises operating efficiency improvement, investing in profitable projects and terminating unprofitable projects and a judicious use of finances to create value. The models of Copeland, Koller and Murrin [1990], Crum and Goldberg [1998], Porter [1985] and Rappaport [1986] show the determinants of value creation in a business. The restructuring pentagon of Copeland, Koller and Murrin [1990] indicates that the firm value will increase by internal and external restructuring of a business. They argue that even if a business is to be sold, internal and external restructuring of the business can increase the value of the business and the bargaining potential of the seller. The Crum and Goldberg [1998] Potential and Resilience Evaluation (PARE) Model also focuses on value creation and shows that innovation ability, implementation capability, vulnerability position and reserve capacity are the main determinants of creating value in a business. PARE helps in assessing the viability of an enterprise and also indicates corrective actions that management needs to take to enhance firm value. The Porter’s [1985] Value Chain Model indicates that cost leadership and differentiation help the company to create value. Controlling the cost drivers, reconfiguring the value chain and becoming unique in some dimensions creates value. Porter argues that value is created when a firm creates competitive advantage for its buyers, lowers its buyers cost or raises its buyers’ performance. In addition, Porter [1985] argues that industry attractiveness and company’s position within its industry determine the profitability of the company. The Rappaport [1986] Value Creating Network Model shows that managers’ decisions on operations, investments and finances create value and it aligns the value drivers to the enterprise objective of value creation. This model also tries to link management decisions to value drivers.

The literature review on restructuring and value creation experiences and models used in developing and transition economies reveal that operations, investment and financial restructuring are needed to create value in a business. The restructuring experience of the developed economies shows that financial restructuring creates value because it does not bring change in company management. Since the managers know more about the company than outsiders they can introduce changes in operations and investments once they get access to finance [Bowman, 1999]. The study of Bowman et al. [1999] shows that spin-offs and sell-offs create value, but acquisition and divestment on average do not create value. Labour reduction, unless accompanied by other organisational changes, does not increase firm value.

The restructuring experience of transition economies indicated that there is even a greater need for restructuring of enterprises than in those enterprises in the developed economies. Some researchers have argued that the managers in transition economy countries cannot become market-oriented. However, the studies of Pinto, et al. [1993] and Aghion, Blanchard and Burges [1994] show that managers are restructuring their companies because it shows their management ability and it helps them to get career opportunity after privatisation. In the transition economies also governments are engaged in financial restructuring of companies to reduce the debt accumulation in companies in order to attract buyers during privatisation. Many governments directly wrote off the debt. However, this creates moral hazard if this is done repetitively, because it then gives managers an idea that the government will bail out the
financially troubled companies and it destroys the credibility of the reform process. The workers were electing managers or their union was approving managers’ appointments and thus the managers were not able to introduce changes that had impact on workers. Due to this, performance of the enterprises did not increase. However, the Polish attempt of assigning enterprise restructuring to the banks had some positive influence on enterprise performance. The banks created departments staffed with experts in managing financially troubled companies and also participated in the governance of the enterprises as boards. The bank led enterprise restructuring also provided several alternative methods of reducing the enterprise debt such as debt-for-debt swaps, debt-to equity swaps and debt sale.

There are three options for sequencing restructuring and privatisation in transition: restructure fully before privatisation, partial restructuring before sale or sell the company ‘as is’. The best scenario is restructuring enterprises fully prior to sale because-as discussed in Copeland, Koller and Murrin [1990]-internal and external restructuring create value and enhance the bargaining power of the seller. In addition, during transition, the state-owned enterprises are considered the wealth of the society and selling companies at low prices has political repercussions. The people of the transition economy countries believe that selling companies at a low price without restructuring is giving away the wealth of a society to a few private individuals. Moreover, there is uncertainty of potential restructurability of the enterprises and since the managers know their companies better than outsiders, they will be better equipped to restructure the enterprises than outsiders. The buyers also will be happy to acquire restructured companies because it reduces the uncertainty of restructurability of the enterprise to be sold. For all parties, selling the restructured enterprises is the best option. However, when restructuring is not easy due to a lack of qualified managers who can turn ailing companies around and a lack of finance, government can partially restructure enterprises before privatisation by labour reduction, debt reduction and increasing the autonomy of the organisations. The new buyer can complete the restructuring process after privatisation. The selling process takes time and thus, simply waiting to find a buyer creates uncertainty and destroys value creation potential of the enterprises. It also drains the government budget. Segregating unprofitable business units and restructuring large conglomerates into viable business entities enhance the saleability and viability of enterprises. The governments of transition countries need to engage on defending the vulnerability position of the company by providing finances and strengthening management of the companies to help them compete in the market economy. The third option selling ‘as is’ should, finally, be used in those viable enterprises that do not require restructuring because they attract buyers. This will also facilitate privatisation of the rest of the enterprises because the government can then focus on the ailing companies that require restructuring to make them saleable and viable.

The studies of Earle, Estrin and Leschenko [1996] and Gurkov [1997] helped us to identify the value creating restructuring activities and problems that the enterprises in transition face. We used these activities and problems in designing questionnaires in our empirical study.