Companies have …

- Companies with household names and famous products … (Jet Airways, Mafatlals, Ambalal Sarabhai)
- Companies with assets in crores … (Tata Tel, Jessop, Bangurs)
- Companies with thousands of employees … (Satyam, Ispat)
- Companies with once enviable reputation in the stock exchanges … (SIV Industries, Silverline, Unitech)
- Companies with seemingly unassailable positions in their markets ... (Metal Box, Arvind Mills, Mukand)
- Companies, which were the darlings of Financial Institutions and Banks … (Essar, Kingfisher Airlines, Modi Tyres, Suzlon)
- Companies which issued shares at a premium … (Lanco Infra, IVRC, Shree Rama Multi-Tech, Vardhaman Financial Services)

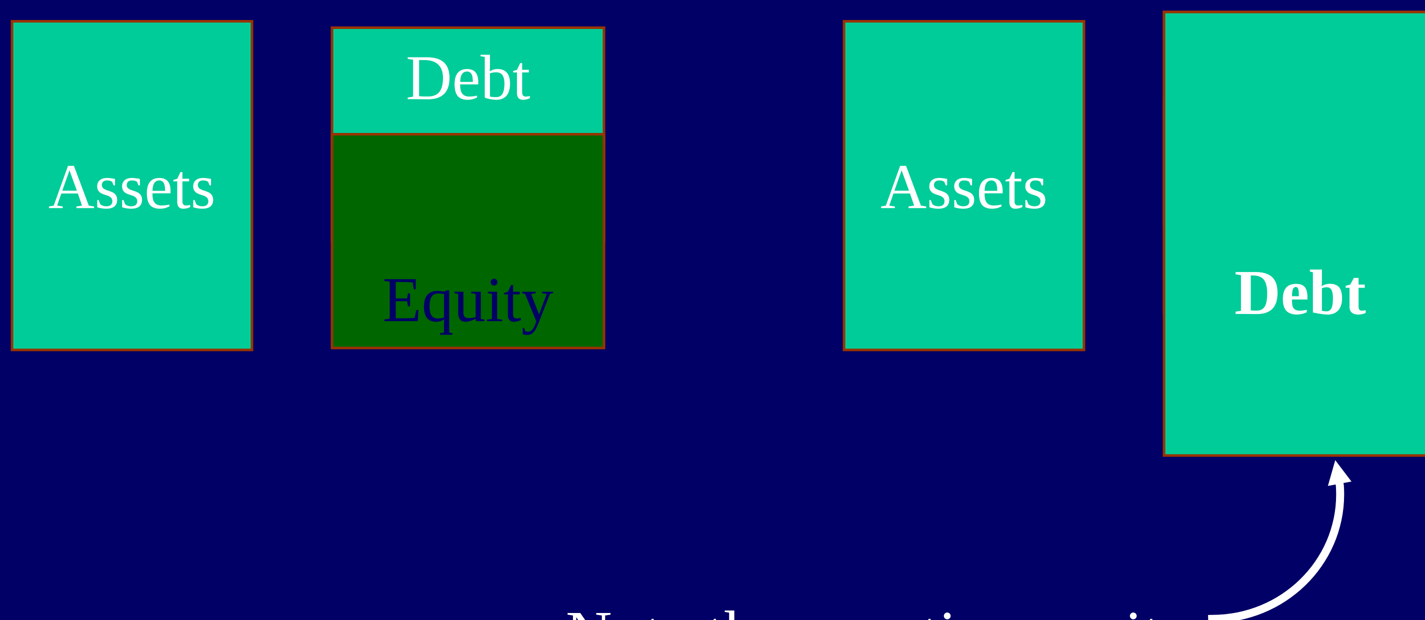
What Is Financial Distress?

- Financial distress is a situation where a firm's operating cash flows are not sufficient to satisfy current obligations, and the firm is forced to take corrective action.
- Financial distress may lead a firm to default on a contract, and it may involve financial restructuring between the firm, its creditors, and its equity investors.

Insolvency

- Stock-base insolvency: the value of the firm's assets is less than the value of the debt.

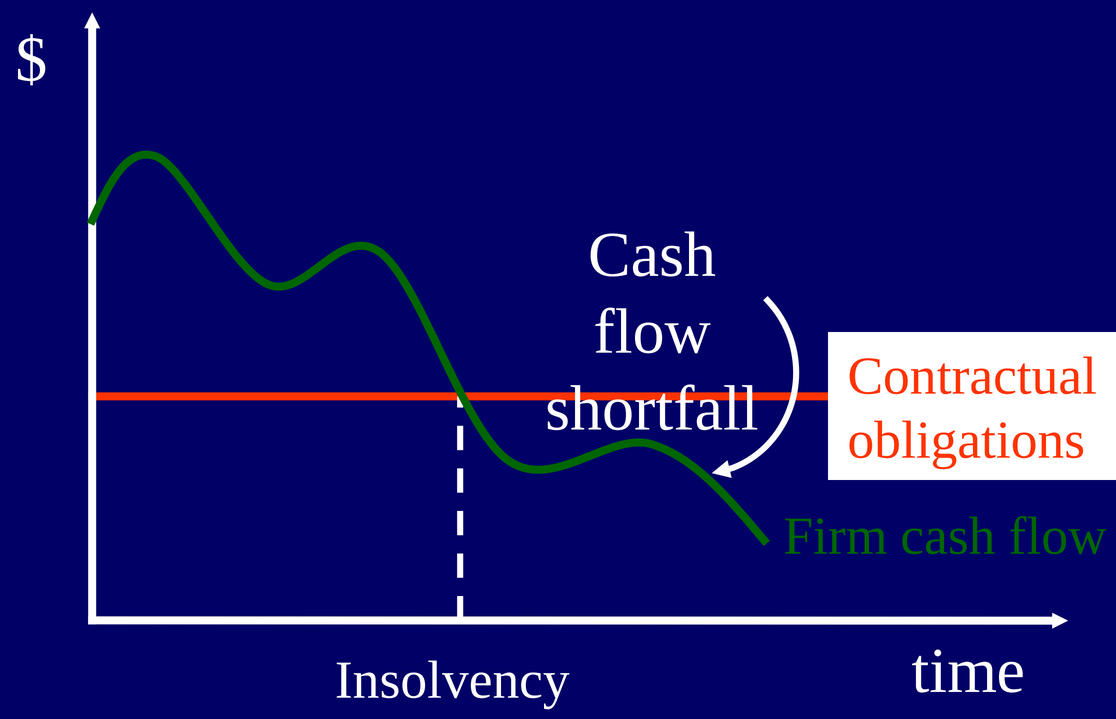
Solvent firm | Insolvent firm



Note the negative equity

Insolvency

- Flow-base insolvency occurs when the firms cash flows are insufficient to cover contractually required payments.



Major Causes of Business Failure

- The primary cause of failure is mismanagement, which accounts for more than 50% of all cases.
- Mismanagement includes inappropriate working capital estimates and highly ambitious plans.
- Economic activity -- especially during economic downturns -- can contribute to the failure of the firm.
- Business failure may also result from corporate maturity because all firms and business models need not have infinite lives.

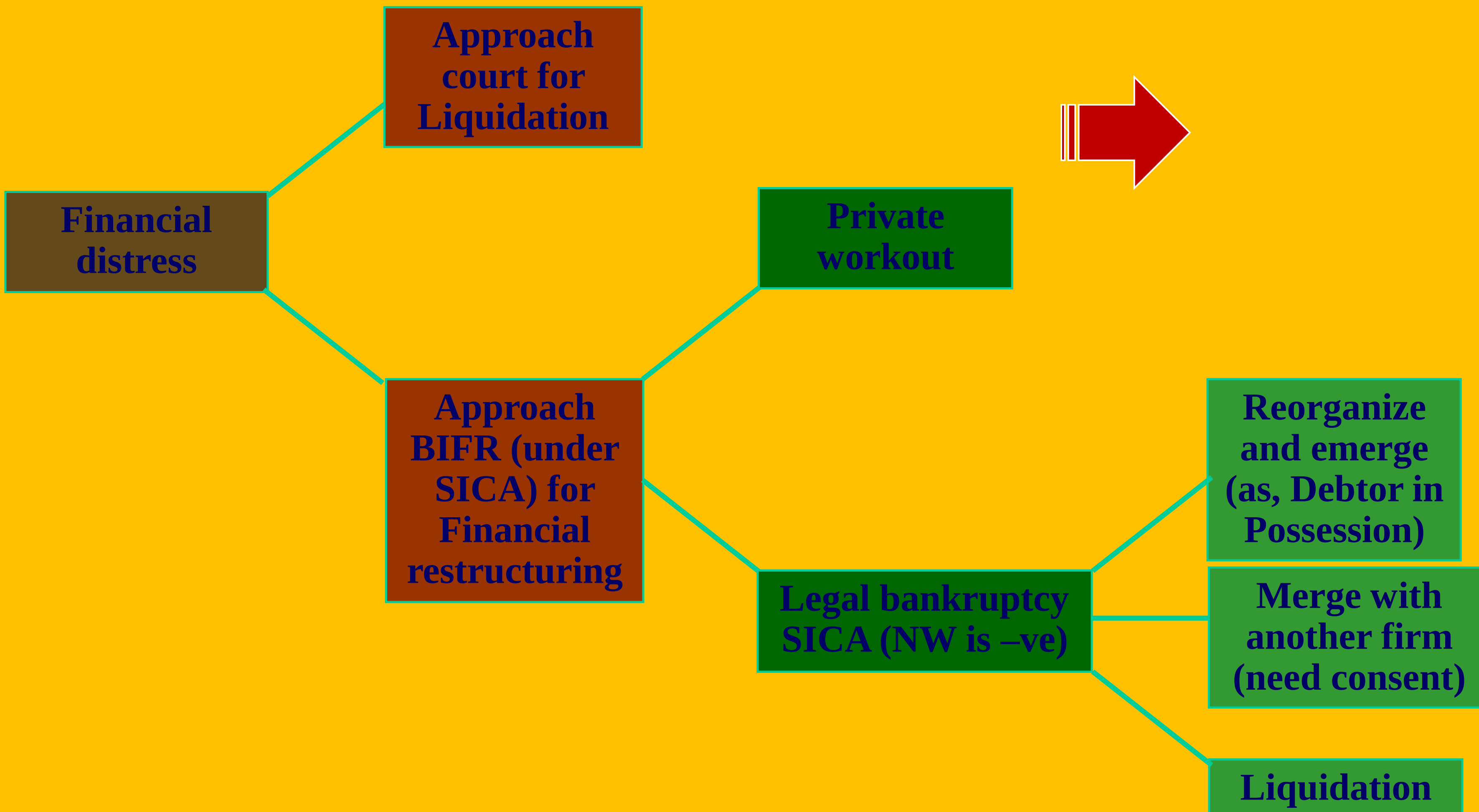
What Happens in Financial Distress?

- Financial distress does not usually result in the firm's death.
- Firms deal with distress by:
  - Selling major assets.
  - Merging with another firm.
  - Reducing capital spending and research and development.
  - Issuing new securities.
  - Negotiating with banks and other creditors.
  - Exchanging debt for equity.
  - Filing for bankruptcy.

Bankruptcy Legislation

- Bankruptcy in the legal sense occurs when the firm cannot pay its bills or when its liabilities exceed the fair market value of its assets.
- However, creditors generally attempt to avoid forcing a firm into bankruptcy if it appears to have opportunities for future success.
- In India, the Board for Industrial & Financial Reconstruction (BIFR) and Sick Industrial Companies Act (SICA) are the current governing bankruptcy legislation.
- In US, chapter 7 (liquidation) and chapter 11 (reorganization) are the governing bankruptcy legislation

What Happens in Financial Distress?



- Chapter 11 proceedings are in some way similar to proceedings under the Sick Industrial Companies (Special Provisions) Act, 1985 (“SICA”).
- Under SICA, the directors of a company (or certain third parties), whose accumulated losses exceed its net worth can make a reference to the Board of Industrial and Financial Reconstruction (“BIFR”) for determining measures to be taken with respect to the “sick company”. Before the BIFR completes its inquiry, the “sick company” or third persons can apply to the BIFR for continuing the operations of the sick company or suggesting a scheme for financial re-organisation.
- 1. Voluntary Petition by debtor / Involuntary Petition by Creditors
- 2. Creditors’ Committees set up to participate in re-organisation process
- 3. Proof of Claims submitted by creditors
- 4. Preparation and Submission of Re-organisation Plan
- 5. Confirmation of Plan by the Court
- 6. Final Decree by court once estate is fully administered

Concepts of restructuring

- Rearrangement of a debtor’s financial commitment
  - Consensual process without supervision
  - Involvement of lenders (some cases even creditors) essential
- Triggered by an actual or potential default
- Typical steps include
  - Entering of standstill agreement
  - Negotiation on restructuring package
  - Approval of restructuring package
  - Negotiation/implementation of restructuring package
- Restructuring may include interest funding, conversion of debt to equity/convertible

Restructuring in India

Contracted

CDR

- *Forum of lenders*
- *For debt > INR 100.0 million*
- *Restructuring to be approved within 90 days*
- *To be approved by75% lenders by value, 60% in number*
- *Standstill period - 90 days (only for CDR lenders)*
- *CDR organization – CDR standing forum, CDR empowered group, CDR cell*

Court approved

SICA + Companies Act → **BIFR** | **CLB** | **High Court**

Scheme of arrangement	*Sick company re-structuring*
• **Described in companies act** • **Compromise among lender & borrower** • **Creditors must be divided in classes** • **75% of each class must vote in favor** • **Court must sanction the scheme** • **Binding on all after HC approval** • **Standstill period can be allowed while approvals are pending**	• **SICA applies to certain companies only** • **For BIFR companies - BIFR operates a restructuring agent** • **BIFR schemes binding on all lenders** • **To prevent abuse of SICA, SARFAESI was passed** • **Under SARFAESI secured creditors can have certain self help remedies**

Else liquidation

Bankruptcy Liquidation

Straight liquidation under BIFR:

1. A petition is filed in a court. The debtor firm could file a voluntary petition or the creditors could file an involuntary petition against the firm.
2. A trustee-in-bankruptcy is elected by the creditors to take over the assets of the debtor firm. The trustee will attempt to liquidate the firm's assets.
3. After the assets are sold, after payment of the costs of administration, money is distributed to creditors.
4. If any money is left over, the shareholders get it.
5. Usually, this is done through AAIFR (Appellate Authority for Industrial and Financial Reconstruction)

Bankruptcy Liquidation: Priority of Claims

Liquidation proceeds are distributed in order of priority:

1. Secured creditors (by sale of secured assets)
2. Administration expenses associated with liquidation
3. Wages, subject to limits
4. Tax claims
5. Unfunded pension liabilities, provident fund
6. Unsecured creditors
7. Preference shares
8. Equity shares

Liquidation

- Modes of winding up -
  - winding up by the court (compulsory);
  - voluntary winding up by the members or creditors;
  - voluntary winding up subject to supervision of the court.
- Compulsory winding up -
  - if no business is done for a whole year;
  - if reduction in number of shareholders;
  - if unable to pay its debts;
  - if the courts order (due to a petition);

Case of

CORE HEALTHCARE (Core Group)

Core Healthcare		Financials Rs (in Cr		Financials Rs (in Crores)		
For the year	203	103	00	99	98	97
Operating Income	123.11	103.79	157.98	301.83	254.04	172.8
Net Profit	-130.3	-172.54	-265.46	-136.73	-96.23	-77.82
Net Worth	-741.31	-614.29	-407.69	-37.99	154.74	305.88
No. of Shares (in crore)	3.58	3.58	3.4	3.4	3.4	3.4
Adjusted EPS (Rs)	-47.09	-48.44	-89.45	-37.81	-26.96	-22.47
Book value per Share (Rs)	-205.59	-170.11	-113.9	-10.61	43.23	85.46
Dvdnd per Share (Rs)	0	0	0	0	0	0
Net Profit Margin (%)	-104.8	-165.08	-202.02	-44.56	-37.83	-45.31
Current Ratio	0.93	0.82	0.97	3.55	4.4	4.39
Lt Debt Equity				13.31	3.96	2.13

BIFR judge had observed that property grabbers, tax evaders, bank loan dodgers and other unscrupulous persons from all walks of life find the court process a convenient lever to retain the illegal gain indefinitely (indiabullls.com and Economic Times)

Voluntary Settlements

- A voluntary settlement is an arrangement between a technically insolvent or bankrupt firm and its creditors enabling it to bypass many of the costs (& delays) involved in legal bankruptcy proceedings.
- Example … SPIC Petrochem
- An extension is an arrangement whereby the firm's creditors receive payment in full, although not immediately.
- Example … Essar Steel
- Composition is a pro rata cash settlement of creditor claims by the debtor firm where a uniform percentage of each Rupee owed is paid.
- Example … Siemens India

Voluntary Settlements

- Creditor control is an arrangement in which the creditor committee replaces the firm's operating management and operates the firm until all claims have been satisfied.
- Example … Modi Rubber
- Assignment is a voluntary liquidation procedure by which a firm's creditors pass the power to liquidate the firm's assets to a bureau (DRT), a trade association, or a third party, which is designated as the assignee.
- Example … Mardia Chemicals (Debt Recovery Tribunal)

Internal Reconstruction

- If there are chances of survival, then
- management approaches the stakeholders in general with a scheme of internal reconstruction
- this scheme should spell future prospects with adequate reasons
- usually requires some sacrifice from the stakeholders
- question is who will make the sacrifice?
- Equity shareholders, preference shareholders, …

Case of

ARVIND MILLS (Lalbhai Group)

	Case of Arvind Mills - Financial Highlights				
	1995-96	1996-97	1997-98	1998-99	1999-00
Net Worth	1047	1065	1158	1163	891
Equity Capital	100	101	101	101	101
Preference Capital	0	0	39	69	69
Borrowings	715	1052	1559	1936	1973
Total Funds	1762	2117	2717	3099	2864
Sales	709	863	933	906	1216
PAT	114	127	101	14	-271
EPS	11.4	12.7	10.1	1.4	-27.0
Book Value	104.8	105.9	115.2	115.7	89.0
DPS	4.5	4.5	2.5	0.0	0.0
Share Price	140	125	124	65	34
Market Capitalizatio	1400.0	1262.5	1252.4	656.5	343.4

Source: www.arvindmills.com and www.indiabulls.com

Case of Arvind Mills

Period 1997-2000:

- Rapidly expanding into denim (on McKinsey's Advice)
- Time and cost overruns in projects
- Increase in manufacturing costs
- Increase in financial costs (five times)
- Falling global denim prices

Period 2000:

- Attempted selling some assets, etc - failed
- Appointed Technopak, Jardine Fleming, Chase Manhattan
- Restructuring: Debt buyback worth Rs. 55 crores, rights issue, promoters pumped in more money, sale of land/assets, waiver of interest

Case of Arvind Mills

Restructuring Package:

- Scale down denim expansion
- Diversify its portfolio
- Debt Package
- Buyback 550 Cr of its debt at 55% discount
- Lender to be paid 48% of principal in full settlement if agree to re-invest 6.42% of principal in rupee denominated debt
- Extend tenure to 10 yrs instead of 7, with lower interest rate of 9%. (12.5% when performance good)
- Average maturity of debt changed from 4 yrs to 8 yrs
- Financial charges halved to 180 cr

Case of Arvind Mills

It was decided in the Extraordinary General Meeting held on 12th June 2001 that:

- Rights issue in 3:4 ratio at par (Rs. 75 crores)
- Issue of upto 4.03 crore convertible warrants to certain lenders
- Issue of secured optionally partly convertible debentures with warrants attached aggregating Rs. 50 crores to certain lenders

Date: 2 May 2002

- Jan.-Mar. 2002 was the first quarter in the last three and half years that the company had earned a clean net profit (no manipulation, no adjustments, other incomes, etc.).

	Case of Arvind Mills - Financial Highlights					
	1998-99	1999-00	2000-01 (18m)	2001-02 (6m)	2002-03 (12m	2003-04
Net Worth	1163	891	391	906	1064	1181
Equity Capital	101	101	101	140	175	195
Preference Capital	69	69	69	69	69	69
Borrowings	1936	1973	2327	1638	1340	1355
Total Funds	3099	2864	2718	2545	2405	2537
Sales	906	1216	1850	698	1551	1458
PAT	14	-271	-499	20	129	97
EPS	1.4	-27.0	-49.0	2.9	7.0	4.5
Book Value	115.7	89.0	39.0	59.8	56.6	57.0
DPS	0.0	0.0	0.0	0.0	0.0	0.0
Share Price	65	34	10	13	28	70
Market Capitalizati	656.5	343.4	101.0	182.0	490.0	1365.0
Source: arvindmills.com, moneycontrol.com, and indiabulls.com						

Bankruptcy Reorganization: SICA

A typical sequence:

1. A voluntary petition or an involuntary petition is filed.
2. A judge either approves or denies the petition.
3. In most cases the debtor continues to run the business.
4. The firm is given 120 days to submit reorganization plan.
5. Creditors and shareholders are divided into classes. Requires only approval by key creditors owning 2/3 of outstanding debt.
6. After acceptance by the creditors, the plan is confirmed by the court.
7. Payments in cash, property, and securities are made to creditors and shareholders.

Case of

AMIT SPINNING (Bharat Shah Group)

Beginning of Amit Spinning

- 1993: Incorporated

- 1993: Offered 6.95* million Rs10 equity shares (at par)
  - 1500k shares to NRIs
  - 600k shares to the Arunoday Mills shareholders
  - 150k shares to employees
  - 4500k shares to the public

- 1997: Issued 300k-16% Redeemable Cumulative Preference shares of Rs. 100 (redeemable at par after 5 years)

	Case of Amit Spinning - Financial Highlights				
	1999-00	2000-01	2001-02	2002-03	2003-04 (18m)
Net Worth	27	28	24	12	-4
Equity Capital	17	17	17	18	18
Preference Capital	4	4	4	4	4
Borrowings	55	71	78	81	84
Total Funds	82	99	102	93	80
Sales	94	87	87	78	92
PAT	2	2	-3	-13	-16
EPS	1.0	0.6			
Book Value	13.0	14.0	12.0	4.3	-4.5
DPS	0.5	0.0	0.0	0.0	0.0
Share Price	13	8	3	4	7
Market Capitalizati	22.1	13.6	5.1	7.2	12.6
Source: bseindia.com, nseindia.com, moneycontrol.com					

Amit Spinning: Bad Days

- 2002: issued 10,90,000 equity shares to IDBI in terms of Company's restructuring proposal to reduce the interest and deferment of principal payments, as approved by IDBI
- May, 2004: application to the FIs & Banks to restructure its term loans and reduction of cost of interest approved under the CDR Plan

Amit Spinning

- Sep, 2004: EGM approved:
  - Reduction of 50% of Share Capital
  - Alteration in Memorandum of Association & Articles of Association
  - Re-classification of Authorised Share Capital
  - Conversion of 300k - 12% Redeemable Cumulative preference Shares of Rs 100 /- each into 6000k Equity Shares of Rs 5/- each.
  - Issue and allotment of equity shares of Rs 2 crores (inclusive of premium) to Promoters

CDR proposal

- De-rating of equity share capital by 50%
- Promoters to bring in additional contribution of Rs.2 crores
- Preference shares of Rs.3 crores held by the promoters to be converted to equity shares

CDR proposal

- Working capital irregularities to the tune of Rs.13 crores to be converted to a LT loan with interest @ 9.5%
- Loans of IDBI & Bank of India, at interest @ 9% as against 14% p.a.
- TUF loan at 10.5% instead of 14%
- Term loan by SICOM @ 14% to be now at their minimum reference rate of 12.5% (if it is reduced, the benefit to be passed on)

CDR proposal

- All the liquidated damages / penal interest charged by the FIs / banks from April 01, 2003 to be refunded
- Reschedulement of the loans in a staggered manner
- Cut off date for the package: April 01, 2003

Bankruptcy Prediction Models

- Started by Altman (Z-score model)
- Using Multiple Discriminant Analysis
- Take all financial numbers including liquidity, solvency, and profitability ratios. Also include non-financial measures.
- Remove the overlapping ones & perform analysis
- $Z = 0.012X_1 + 0.014X_2 + 0.033X_3 + 0.006X_4 + 0.999X_5$
- X_1 is WC/TA; X_2 is RE/TA; X_3 is PBIT/TA; X_4 is MVE/BV of TD; X_5 is Sales/TL
- But the models will be different for different contexts
- We can have economy specific/ period specific/ sector specific models