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Financial Restructuring in India - a way to tackle Global Financial Crisis

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Abstract

Within few years globalisation has brought in new opportunities to developing countries and greater access to developed country markets and technology transfer. However, it has also thrown up challenges like growing inequality across and within nations and volatility in financial markets. The turmoil in the international financial markets of advanced economies, which started brewing around mid-twenties, has exacerbated substantially since few years. While the developed world, especially the Western Countries, has plunged into recession, the Indian Economy is being affected by the spill-over effects of the global financial crisis.

The global crisis has affected India through three distinct channels: financial markets, trade flows, and exchange rates, leading to reversal in capital inflows and a situation of credit crunch in domestic markets. This has induced the need for financial restructuring and has made it imperative to evaluate the impact of financial restructuring on the overall well-being of the economy. Financial restructuring is the process of reshuffling or reorganizing the financial structure, which primarily comprises of equity capital and debt capital. Thus there is a need for the organizations to understand the significance of financial restructuring in the current economic scenario and vital for the government to bring out policies, which will help the organizations achieve the same.

Therefore, this paper attempts to trace out the need of restructuring to minimize the impact of global financial crisis on India.

Key Words: Globalisation, Financial Crisis, Financial Restructuring

Introduction

The global financial crisis of 2008–2010 has left an everlasting impact on the global economy. This financial crisis morphed in to a full-blown global economic downturn leading to the developed world, especially the Western Countries, plunging into recession. India's financial sector was not deeply integrated with the global financial system therefore relatively insulated from the adverse effects of global financial crisis directly. However, being a part of world economy Indian Economy was also being affected by the spill-over effects of the global financial crisis. The global crisis has affected India through three distinct channels: financial markets, trade flows, and exchange rates. The reversal in capital inflows, which created a credit crunch in domestic markets along with a severe deterioration in export demand, contributed to the decline of gross domestic product. External credit flows suddenly dried up and the market interest rate had spiked up. It is perhaps judicious to assume that the impacts of the global economic downturn on the Indian economy are still unfolding. This paper tries to focus on the impact of the global financial crisis on the Indian economy and advocates the need of financial restructuring in India to ensure the economy is on track (Mohan, 2006).

Conceptual Framework

Financial restructuring has been a process of reshuffling or reorganizing the financial structure of a company, primarily comprising of equity capital and debt capital. It is reorganizing of a business' assets and liabilities and can be done either through compulsion or as part of the financial strategy of the company. This financial restructuring can be either from the assets side or the liabilities side of the balance sheet. If one is changed, accordingly the other will be adjusted. It embroils corporate restructuring where an organization's overall structure and its processes are revamped. Restructuring is mostly done when companies are facing serious problems with the business or to circumvent bankruptcy liquidation. Every functioning company controls assets, or economic resources that can be owned and are otherwise considered valuable. Most businesses also hold liabilities, which are debts or other obligations that arise as a result of past transactions. These economic factors will often have the most significant impact on the success or failure of that business. Thus it has now become imperative for Indian companies to focus on financial restructuring in order to effectively manage their assets and reduce liabilities for minimizing the impact of global financial crisis.

Components of financial restructuring

- Debt Restructuring
- Equity Restructuring

I. Debt Restructuring

Debt restructuring is the process of reorganizing the whole debt capital of the company. It involves reshuffling of the balance sheet items as it contains the debt obligations of the company. Debt restructuring is more commonly used as a financial tool than compared to equity restructuring. This is because a company's financial manager needs to always look at the options to minimize the cost of capital and improving the efficiency of the company as a whole which will in turn call for the continuous review of the debt part and recycling it to maximize efficiency.

Debt restructuring becomes essential when a company is in crisis and is dire need to renegotiate with its creditors to reduce or eliminate its debt component. There is a likelihood that the distressed company may default on a loan inducing the creditors to adjust their terms of repayment either by lowering the interest rates and/or extending the repayment schedule. Debts may also be forgiven, in part or full, in lieu of the creditor gaining some equity ownership in the company. Financial restructuring is not only a tool used by companies that are in financial trouble. Healthy companies may also choose to restructure their debt if it is advantageous to them. Companies refinance its loans to take advantage of the change in interest rates (Venkiteswaran, 1997).

Components of debt restructuring

The components of debt restructuring are as follows

- Restructuring of secured long-term borrowings
- Restructuring of unsecured long-term borrowings
- Restructuring of secured working capital borrowings
- Restructuring of other term borrowings

Restructuring of secured long-term borrowings: Restructuring of secured long-term borrowings will be done for the following reasons such as reducing the cost of capital for healthy companies, for improving liquidity and increasing the cash flows for a sick company and also for enabling rehabilitation for that sick company.

Restructuring of unsecured long-term borrowings: Restructuring of the long-term unsecured borrowings will be done depending on the type of borrowing. These borrowings can be public deposits, private loans (unsecured) and privately placed, unsecured bonds or debentures. For public deposits, the terms of deposit can again be negotiated only if the scheme is approved by the right authority.

Restructuring of secured working capital borrowings: Credit limits from commercial banks, demand loans, overdraft facilities, bill discounting and commercial paper fall under the working capital borrowings. All these are secured by the charge on inventory and book debts and also on the charge on other assets. The restructuring of the secured working capital borrowings is almost all the same as in case of term loans.

Restructuring of other short term borrowings: The borrowings that are very short in nature are generally not restructured. These can indeed be renegotiated with new terms. These types of short-term borrowings include inter-corporate deposits, clean bills and clean over drafts.

II. Equity Restructuring

Companies that have little debt in comparison to their equity that is, they are underleveraged or have a low debt-to-equity ratio may use some of their equity to buy back stock. If the company has excess cash, it can use it to repurchase shares; alternatively, if it doesn't have extra cash available, it may sell off some assets that are not bringing in profits or borrow money for the buyback. Financial restructuring can also involve writing down assets that are overvalued. This change in value appears on a company's income statement as an expense, which lowers the company's income and, therefore, the amount of tax it owes.

Equity restructuring is the process of reorganizing the equity capital. It includes reshuffling of the shareholders capital and the reserves that are appearing in the balance shee0t. Restructuring of equity and preference capital becomes a complex process involving a process of law and is a highly regulated area. Equity restructuring mainly deals with the concept of capital reduction.

The following are the some of the various methods of equity restructuring.

- Repurchasing the shares from the shareholders for cash can do restructuring of share capital. This helps in reducing the liability of the company to its shareholders resulting in a capital reduction by returning the share capital. The other method that falls in the same category is to change the equity capital in to redeemable preference shares or loans.
- Restructuring of equity share capital can be done by writing down the share capital by certain appropriate accounting entries. This will help in reducing the amount owed by the company to its shareholders without actually returning equity capital in cash.
- Restructuring can also be done by reducing or waiving off the dues that the shareholders need to pay.

Therefore, restructuring can also be done by consolidation of the share capital or by sub division of the shares

Why is Financial Restructuring needed in India?

Most Indian Organizations are going through a phase of financial restructuring. In some cases, the process of restructuring has taken place as a means of allocating resources for a new marketing campaign or the launch of a new product line. When this happens, the restructure is often viewed as a sign that the company is financially stable and has set goals for future growth and expansion. A company may also need to restructure its finances if it merges with or acquires another company. When two firms merge, their debt and equity are also combined, and the resulting corporation may have a very different debt-to-equity ratio than either of the original companies. An acquisition may even be used as a form of financial restructuring, as a company with a low debt-to-equity ratio may target a business with a high ratio as a means of better balancing its finances.

Operational restructuring

Further, Companies have also adopted operational restructuring as a means to eliminate waste. When two divisions or departments of a company perform similar function or in some cases duplicate efforts, rather than continuing to use financial resources to fund the operation of both departments, their efforts can be combined (Prasad, Raghuram and Subramanian 2007). This helps to reduce costs without impairing the ability of the company to achieve the same ends in a timely manner. Therefore, operational restructuring has helped the organisations in downsizing or eliminating staff to reduce costs.

Financial restructuring has also helped the companies in a situation when its sales declined and the corporation no longer was able to generate a consistent net profit. The operational restructuring process included a review of the costs associated with each sector of the business and an analysis of ways to cut costs and increase the net profit. The process also called for the reduction or suspension of obsolete facilities that produced goods that were not selling well and were scheduled to be phased out (Laeven and Valencia, 2008).

Debt restructuring

Debt restructuring can be done based on different circumstances of the companies. These can be broadly categorized in to 3 ways.

1. A healthy company can go in for debt restructuring to change its debt part by making use of the market opportunities by substituting the current high cost debt with low cost borrowings.
2. A company that is facing liquidity problems or low debt servicing capacity problems can go in for debt restructuring so as to reduce the cost of borrowing and to increase the working capital position.
3. A company, which is not able to service the present financial obligations with the resources and assets available to it, can also go in for restructuring. In short, an insolvent company can go for restructuring in order to make it solvent and free it from the losses and make it viable in the future.

Equity restructuring

The following are the reasons for which equity restructuring is done:

- Correction of over capitalization
- Shoring up management stakes
- To provide respectable exit mechanism for shareholders in the time of depressed markets by providing them liquidity through buy back.
- Reorganizing the capital for achieving better efficiency
- To wipe out accumulated losses
- To write off unrecognized expenditure
- To maintain debt-equity ratio
- For revaluation of the assets
- For raising fresh finance

Conclusion:

Financial Restructuring is thus becoming the need of hour in terms of global turmoil and the Indian Companies have to look at it seriously in order to face the global financial crisis. The Indian Government should act as a good support system and provide the necessary impetus to the companies to achieve restructuring successfully.

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