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Comment on 'Corporate Restructuring in Response to Performance Decline: Impact of Ownership, Governance and Lenders'

COLIN MAYER
School of Management Studies, Oxford University

There is a substantial and growing literature on corporate restructuring. At both the theoretical and empirical level there have been significant advances in our understanding of the control of firms over the last few years. The theoretical work has focused on the influence of ownership and financial structure on the operation of firms. In particular, there has been a strand of literature which has considered the significance of ownership and financial structure in the context of incomplete contract models.

At the empirical level, the influence of four groups of variables on restructuring has been emphasized. The first and most obvious is corporate performance. A variety of measures of accounting and share price performance have been used as indicators of poor performance. The second group of variables relate to the ownership structure of firms. Ownership concentration in particular is regarded as being an important influence on corporate control and performance. The third set of variables is board structure and in particular the role of non-executive directors on the board of firms. The fourth is the financial structure of firms, especially levels of gearing.

The contribution of this paper is to put together all of these potential influences in an examination of how ownership, board structure and financial structure impact on the restructuring of poorly performing firms. The paper organizes this analysis in a particularly interesting way, suggesting that different parties have varied objectives in the restructuring process: shareholders, managers and creditors may pursue different policies in the event of poor performance. There are, in other words, conflicts between principals and agents and between different classes of principals.

The way in which this paper suggests that these conflicts manifest themselves is in the pursuit of different restructuring policies. There are four classes of restructuring considered in this paper: operational (cost cutting or expansion), asset (divestments or new investment), managerial (replacement of top management) and financial (additional borrowing, new equity and dividend cuts).

In general, restructurings would be expected to be encouraged by the presence of large shareholders, a large number of outside directors and high levels of gearing. But the nature of the restructuring should differ. Large shareholders are predicted to seek reductions in operational expenditures, sales of assets (unless they are primarily for the benefit of creditors), replacement of management and injections of additional borrowing. They should not favour asset sales which primarily benefit creditors. Managers are expected to prefer to expand their way out of trouble by increasing operational expenditures and undertaking new investment financed from outside sources, either debt or equity. They will resist changes in membership of boards,

Banks, like shareholders, will seek reductions in operational expenditure and sales of assets and they too will expect higher turnover of management during periods of poor performance. However, in contrast to shareholders, banks are expected to seek external equity rather than debt capital.

The paper looks at 297 firms which went through a dramatic decline in performance from being in the top 50% of share price returns in two successive years to being in the bottom 20% over the period 1985 to 1993. It reports that the most common form of restructuring is operational. Managerial restructuring is observed in less than one quarter of companies experiencing sharp performance declines. There is a higher level of asset sales in the sample of firms suffering a performance decline than in the population of UK listed firms. Equity issues are not higher than average but dividend cuts and omissions are.

The paper reports the results of two analyses of the influence of dominant parties on restructuring: first a comparison of firms with and without dominant parties and second logit regressions of forms of restructuring on control type and economic/industry conditions. The paper finds that different parties favour different restructuring policies and that many of the above predictions are supported. In particular, lenders favour cash-generating debt restructuring but are opposed in this by block shareholders. Chairmen and CEOs prefer investments and dislike cash-generating strategies and managerial restructuring. However, there are also results which are in conflict with predictions: for example, block shareholders oppose operating restructurings and do not appear to promote more managerial restructuring.

The interesting implication of the paper is that the implementation of particular forms of restructuring will necessitate particular ownership, financial and board structures. Financial structure for example determines the extent to which firms will pursue asset sales as against expansion. This is also the source of the first concern which the paper raises. It only considers the influence of corporate organization on restructuring, not the converse. In practice, the ownership and financial structures of firms are likely to be a function of current and anticipated performance. There is therefore a potential endogeneity problem. Restructuring and firm characteristics should be considered as jointly evolving variables. This is most obviously reflected in the fact that some forms of restructuring, most notably asset sales and new issues, involve changes in ownership and financial structure.

The optimal response to financial distress is likely to be dependent on industry, the nature of the downturn in the performance and the extent to which it is due to economy wide as against firm specific factors. Ownership, financial and board structures will then be chosen to encourage appropriate responses in the face of anticipated shocks and these characteristics should change in response to unanticipated shocks. This would suggest that the analysis could be turned on its head in the sense that ownership, financial and board structures should be a function of industry, technology and firm factors. Changes in ownership, financial and board structures will reflect unexpected changes in the economic and financial circumstances facing firms.

More generally, it is unclear why the authors have chosen to estimate a large number of individual logit regressions. Firstly, there is no reason why the dependent variables, such as capital expenditure and acquisitions, should not be estimated as continuous rather than categorical variables. Secondly, the equations cannot be estimated independently, if only because different forms of restructuring are likely to be complements or substitutes. Thirdly, the presentation of the paper would have been greatly assisted if the regressions had been estimated in a dynamic panel form which would have allowed the evolution of the different variables to have been modelled. The reporting of several years' regressions would thereby have been avoided.

What the paper does not allow is an assessment of the merits of different forms of restructuring or characteristics of firms. For example, it cannot currently be concluded, as is stated at one stage in the paper, that 'the effectiveness of a governance structure (is) characterised by a substantial independent director presence'. One of the criteria by which to judge restructurings is the speed with which they are implemented; in general, their effectiveness is reflected in the subsequent performance of firms. There is no evidence on this in the paper. In particular, we do not know how performance of firms is affected by decisions to expand rather than contract the asset base of the firm.

In sum, the paper has made a valuable contribution in pointing to the varied nature of corporate restructurings and the role of different parties in organizing these restructurings. It provides a more comprehensive picture of the restructuring process than has been available to date and it identifies some of the conflicts which exist between the interests of different parties in organizing restructurings.