CHAPTER – 1
INTRODUCTION
1.1 BACKGROUND OF THE STUDY

The period before 1991 was known as pre-reforms period wherein the Indian economy was mainly governed through industrial licences and controls, monitored interest rates as well as dominant role played by public sector companies, Government corporations and very few business houses, facing very less competition. Considering the nascent stage of economic development, the system could have been considered as better for the said period but it had made its own impact such as uneconomic and uncompetitive production systems leading to the higher cost of production and inefficiency. From 1980 onwards, deregulation policy was initiated, the government relaxed entry barrier and slowly and gradually removed certain restricted clauses in the MRTP Act, allowed expansion of capacities, reduced import restrictions as well as encouraged modernization of industries. The high production growth was witnessed during 1980-1990 but again the growth could not be sustained after the 1990s due to various external factors such as sharp increase in the world oil prices, sharp devaluation of Indian rupees and opening up of the economy by adopting various economic reforms during June 1991 which resulted in sudden exposure of Indian industry to the outside world. Rodrik and Subramanian (2004) distinguished between pro-business orientation of the 1980s and the pro-market orientation of the 1990s. According to them, the former focused on rising of the profitability of the established companies by removing price control, reduction in corporate taxes and easy restrictions on capacities for established enterprises which all took place in 1980s drawn to favour incumbents and procedures. On the other hand, pro-market reforms focused on removing impediments for the functioning of the markets, allowing increased competition, both in domestic and foreign front. The pro-market reforms have mainly affected the business environment of the Manufacturing sectors and it had hardly added anything to the aggregate economic performance. Due to these reforms, numbers of industrial companies have started performing from good to bad and bad to worse. As per the World Bank data, during 1985, there were 1,60,000 sick units in India of which only 60 closed during that year. These sick units are performing at the cost of entire
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economy under the guise of public interest by means of various concessions and subsidies in all the forms. Up to 1990, Indian economy and industries per se were not affected by the global market due to the closed economy policy followed by the government. As soon as the reforms in the form of liberalization and globalization policy were adopted, the industries have started feeling sudden jolts from the outside world. Lot of uneconomic and unviable companies had to close down their shutters as they could not face global competition with the reduction in the import duty rates as well as improvement in the infrastructure facilities resulting in reduced transportation cost made various global products cheaper than the countries own product and accordingly the Indian industries had to either make them competitive or to wind up their businesses.

Post liberalization scenario has witnessed reforms in various sectors. The financial sector has taken the lead. After liberalization, the rate of interest in the Indian economy started hardening. Partial capital conversion suddenly increased inflow of foreign currency. The currency now is governed on demand supply basis instead of administered rates which was in vogue prior to 1991. With the change in the government policies, the privatization and globalization have become buzz word in the Indian economy. Money supply has stared making changes from the controlled regime to market oriented mechanism. Rate of interest had to adjust to demand and supply position. The scenario has further changed as capacity expansion in the manufacturing sectors consequently changed the size of the industry. Small sector suffered big blows. The SSI manufacturing industry either has to convert them into mid-sized sector or to be encircled by sickness as economies of scale has played a pivotal role in deciding the fate of Indian industries. Market reforms particularly stock market and FDI guidelines have continuously changed since 1991 to 2007 resulting in constant flow of foreign currency in the Indian economy. Not only the manufacturing sector but also the service sector has witnessed a sea change. The Indian economy felt IT boom which has really given a fillip to the economy. Numbers of small software and IT enabled companies have become giant Organizations. Continuous growth has added in their strength during last two decades. Government has also given thrust to the infrastructure industry.
Infrastructure growth in the country has allowed overall development in the economy as there is a surge in the demand for cement, steel, infrastructure, engineering goods, etc. on one hand and qualified persons particularly engineers on the other hand. During the last three decades, the GDP grew at an average rate of 3 to 3.5% annually whereas during 1980s, the average annual growth rate was at around 5.5% followed by mini crisis during 1990-91 but thereafter the Indian economy has grown at about 6 to 6.5% per annum. 2005-06 onwards the growth rate has accelerated and grown to more than 7% per annum.

On the stock exchange front, except Mumbai Stock Exchange, the other regional stock exchanges have witnessed major blows like various structural problems as well as non-adoption of latest technologies and non-understanding about mergers of various likeminded stock exchanges. These problems inhibited their growth. Banking sector also witnessed altogether a different scenario because of continuous changes. Tightening of the non-performing assets norms categorized into efficient and less-efficient banks which forced mergers of less-efficient banks with other strong banks.

In Post liberalization era, Indian economy witnessed sea changes and industry at large had to pass through rough weather during the last two decades. External competition, large size firms competing with small and medium industries in the country and factors like changes in the economic and political environment in the developed countries directly affected Indian industry. In spite of having inherent strength, some of the industries could not sustain this outside economic forces which led to industrial sickness. Considering this problem, lot of industries has started making full-fledged efforts for financial and technical restructuring, there is a continuous increase in the level of sickness in number of units due to variety of factors such as technology obsolescence, managerial incapability, change in the pattern of the market, size of the unit, lack of adequate funds, international competition, over capacity in the field, etc. However, the major problem lies in the failure of any industry seems to be lack of capacity to raise funds and in spite of technical capability of the promoters, the unit tends to become sick. Lots of efforts have been
made for restructuring sick units. Finance plays a pivotal role in such restructuring. Government in India adopted a number of legal measures for financial restructuring.

Indian economy has witnessed lot of cyclical changes during last 19 years due to liberalization, privatization and globalization (LPG). Following liberalization in 1991, India has made great efforts to foster industrialization with an aim of promoting economic development. Lot of pro market reforms have taken place including focus on removing impediments for the functioning of the market. It has allowed increase in competition both from international and domestic market. The changes in the pro market reforms affect the business environment of the manufacturing sector. Because of the globalization as well as integration of Indian economy with the world economy, new challenges have been thrown open for the corporate sector and they were amenable to the external economic environment. More premature sickness has been witnessed in the Indian corporate sector. It was imperative for the Government to have effective mechanism in place to deal with the corporate sickness or insolvency may help the corporate to close down chronically unviable business so that the entire economic resources of the company can be channelized to the efficient use leading to the increased overall productivity of the economy.

The Corporates in India have undergone an unprecedented structural transformation and have also faced numerous problems during their implementation, expansion, diversification or sustainability of the project. They also faced severe financial crunch at certain point of time. This necessitated study of some empirical consequences. In the above backdrop, this study was undertaken to analyze the effect of financial restructuring on the corporate performance in India having special focus on the post 1991 period. Whether there is improvement in the corporate performance due to restructuring of its finance is a subject matter of the study. Hence an attempt has been made to examine the relationship between the financial restructuring and its impact on the corporate performance in India.
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1.1:1 Motivation:

Certain research question arose when exploring the area of study. They are:

a) Whether industrial sickness is mainly due to lack of finance?

b) Whether financial package/subsidy/reliefs granted to the industries are adequate and with the help of which the company can turnaround its performance?

c) In spite of restructuring, whether the sick firms are working at the cost of economic losses and more so giving rise to similar type of units/management to imbibe the theory?

d) Whether the financial restructuring has been implemented at the right time or lot of time loss has crippled efficiencies of the unit?
1.2 INDUSTRIAL SICKNESS-CAUSES AND CONCEPT OF FINANCIAL RESTRUCTURING

1.2:1 Concept

Corporate restructuring includes financial restructuring, managerial restructuring, technology restructuring, manpower restructuring, organizational restructuring as well as merger, de-merger, acquisition, take over, combination etc.

The Financial Restructuring is a narrow word and it is defined in different form as under:

Financial Restructuring is a process geared to avoid the liquidation of the Company. It involves agreement by third parties to satisfy creditor’s claims under certain terms and conditions. Financial restructuring may also be carried out by concluding an agreement with all creditors of the Company under which creditors will be paid on somewhat different terms than those initially accepted by the Company when credit and loans were extended. This form of financial restructuring enables the Company to continue its operations and minimize creditor’s losses and getting more time for repayment of debt.

Companies use debt restructuring to avoid default on existing debt or to take advantage of a lower interest rate.

A company will often issue call bonds to allow them to readily restructure debt in the future. The existing debt is called and then replaced with new debt at a lower interest rate.

Companies can also restructure their debt by altering the terms and provisions of the existing debt.
Financial Restructuring is also termed as the act or process of changing the terms on the assets and/or liabilities of a company. That is, a company may consolidate its debts, significantly change the size and scope of its operations, and take other measures to reduce the strain of continuing operation. Most companies restructure either as part of a bankruptcy or as an effort to avoid it. 

If the company is restructuring as part of a corporate bankruptcy, it is said to be in receivership

1.2.2 **Corporate Debt Restructuring-Concept:**

The reorganization of a company's outstanding obligations, often achieved by reducing the burden of the debts on the company by decreasing the rates paid and increasing the time the company has to pay the obligation back. This allows a company to increase its ability to meet the obligations. Also, some of the debt may be forgiven by creditors in exchange for an equity position in the company.

1.2.3 **Causes leading to financial restructuring**

When the company cannot meet with its financial obligations or paying the debts when they are due, the company can be considered to lead to a debt trap situation and accordingly the company may face insolvency. Thus, to avoid insolvency problems the financial restructuring is required. The following are the main reasons leading the company to debt trap situation:

1. Financial: Short term funds utilized for long term purpose and there is a cash flow mis-match, Diversion of Funds, Wrong Financial Planning with higher leverage either at conceptual stage or during expansion or diversification, Loose control on Receivables or Unnecessary piling up of Hugh Inventory, etc.
2. Market Driven: Not recognizing the need for change in the market or the products of the company may become obsolete or redundant resulted in poor demand and there is no scope for the company to change the product line/product mix resulted into debt trap situation.

3. Wrong Product/Market: Single customer or few customers to whom the company is catering to and because of change in their product mix or because of insolvency of the customer, huge bad debt occur resulted in the debt trap of the company.

4. Managerial: Management failure which includes acquiring adequate skills or lack of information system leading mismanagement and liquidity crunch situation.

5. Technological: Obsolete technology or huge investments in assets with rapid continuous change in the technology.

6. External Factors such as sudden opening up of economy and cut-throat competition from the foreign players or devaluation of currency when industry depends on heavy imports or devaluation of foreign currency when unit depends upon exports of the said country only.

7. Over Expansion of the Capacity or Untimely diversification.

8. Effect of international market and sudden volatility in the prices leads to insolvency.

9. Other factors such as workers’ strike/lockout, death of key promoter/key technical/managerial person resulted in loss of interest by the management, environmental factors or accident in the factory premises, statutory permissions, etc. which may lead to closure of the plant.

10. Over trading or immature expansion, etc. may lead to debt trap situation.
Figure -1.1 Sickness / Revival of Unit

Source : Adapted from Paper on ‘Sick Industrial Companies; Is Rehabilitation Answer?’ by Abhishek Kumar & Sidhartha Mahapatra with own modification.
1.3 NEED FOR RESTRUCTURING

Number of times a question arises that why sick units should be restructured and make it financially viable. Following are the main reasons for making sick units viable:

- Unless sick units are restructured and make it viable, the assets of the industry remain idle which can cause a great loss to the country.

- A running unit can provide employment to the workers and others. It achieves the social goal of providing employment opportunities to the people at large.

- A running industry can contribute to the exchequer of the Government by way of tax/duties and thus it will definitely help in contributing increase in government revenue.

- When there is a global crisis, as witnessed during 2008, it is the responsibility of the State to provide proper restructuring to all the industries in general so as to give impetus to the economy & take country out of the grip of the recessionary trend.

- To provide restructuring to certain essential product manufacturing companies so that overall industrial growth can be maintained at benchmark level.

- To provide restructuring for better utilization of overall resources of the country.

- To unlock NPA accounts of the bank or not allowing standard accounts to slip to sub-standard accounts or doubtful category, restructuring is always welcome measure to reduce overall NPA of the banking system.
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- To bail out the genuine promoters/genuine industries out of difficulty.

- In case of large industry, where numbers of other industries/ancillaries are dependent on the said large unit, it is desirable to restructure the account of the large unit for not impacting other ancillary industries.

1.3:1 When Not to Encourage

However, financial restructuring should not be encouraged in the following circumstances:

- Elimination of competition by giving concessional treatment to the sick industry keeping other healthy industries suffered.

- Lack of managerial ability of the existing promoters

- Other healthy units shall be tempted to take advantage of concessional treatment by converting themselves into sickness.

- Obsolete technology/obsolete products and not possible to change entire technology with reasonable Capital Expenditure

- Protection to the country’s industry at the cost of quality and cheaper products available from other countries in the world when level playing field is available to the Domestic Industries.
1.4 METHODS OF FINANCIAL RESTRUCTURING

Financial restructuring includes:

- Re-phasement of the Loan
- Re-Schedulement of the Loan
- Re-structuring of the Loan
- Infusion of funds by promoters/Strategic Promoters
- Additional funds to be provided by Banks & FIs at concessional rate of Interest
- Conversion of Part of the Loan in to Equity Capital or Preference Share Capital
- Conversion of Working Capital in to Working Capital Term Loan
- Converting Interest due in to Interest Funded Term Loan
- Amalgamation of Sick Unit with Healthy Unit
- Sale of Excess/Non-Used Assets of Sick Industry
- Change of Management
- De-merger of Undertaking of the Sick Industry and raise funds for the resultant Company
- One Time Settlement with the Banks/Unsecured Creditors/Statutory Creditors and Workers by infusion of funds by Promoters/ Strategic Investors
- Capital Restructuring by Reduction of Capital and Infusion of Additional Funds by Promoters/Investors
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- Reduction or Waiver of Interest/Principal by Banks and Financial Institutions
- Raising of Additional Funds for the Company by mortgaging additional assets of promoters or Pledge of Shares of Promoters
- Partial Sale of Assets/Conversion of Loan in to Equity/Waiver of Interest and Principal/Commencement of Job-work of idle capacity
- Providing Subsidy by Government and Priority in Government Tender
- Providing Additional Loan and Recovery of Old and New Loan through cut back system, etc.

The financial restructuring is achieved either by taking any one of above measure or more than one measures simultaneously.

1.4:1 **Re-phasement of the loan:**

The term re-phasement states that when long term loans are granted to the company, the last date of repayment shall remain unaltered but relief is given to the unit from payment of principal for a temporary period and balance installment shall be increased automatically so that when there is a temporary liquidity crunch with the unit, the re-phasing of loan is undertaken by the banks and institutions.

1.4:2 **Reschedulement of the loan:**

Re-schedulement term itself suggests that the schedule of the loan is changed and accordingly last date of repayment is extended after giving relief from payment of principal amount by the lenders and overall tenure stands elongated.
1.4:3 **Restructuring of the loan:**

The term restructuring suggests that the structure of the loan may be changed and accordingly either working capital loan is converted into working capital term loan (WCTL) (i.e. short term funds not represented by assets are converted into long term loans) or interest accrued and due is transferred into funded interest term loan account (FITL) and/or part of the loan may be converted into redeemable preference share capital or equity capital as well as the last date of the repayment is changed to accommodate losses suffered by the Company and liquidity crunch faced by the company.

1.4:4 **Infusion of funds by promoters/strategic investor:**

While restructuring short term/long term loan, in majority of the cases, term lending institutions insist for promoter's contribution/Strategic Investors (SI) contribution to the extent of certain percentage of sacrifice made by the lenders. In line with the same, promoters/SI will have to bring the contribution either before the restructuring or as per the terms of sanction of the restructuring.

1.4:5 **Additional funds provided by the lenders at concessional rates:**

In case of the financial restructuring, when the viability of the project depends upon certain additional funds to be infused either for acquiring fixed assets (balancing equipments to match with the capacity of the specific division with other divisions) or for working capital requirements, then additional funds are provided by the lenders at concessional rates against additional securities provided by the promoters or as per the terms of the sanction. Normally these additional funds are provided only after looking into all parameters including the securities available to the lenders.
1.4:6 **Conversion of loan into equity:**
As a part of the financial restructuring package, lenders are converting interest or over due principal or unsustainable debts into equity capital or redeemable preference share capital which shall be normally payable to the lenders upon completion of repayment of loan liabilities.

1.4:7 **Conversion of part of the working capital into working capital term loan:**
Units facing the sickness are normally financing their losses out of working capital funds resulting into non-availability of adequate current assets to support the working capital facilities availed from the bank.

At the time of financial restructuring the lenders are carving out the excess borrowing of the borrowers and convert it into working capital term loan which shall be repayable by the borrower as per the schedule decided by the lenders. Part of the working capital shall become long term loan and the unit shall not require to submit any stock or book-debt statement against the same.

1.4:8 **Converting interest due into Funded Interest Term Loan (FITL):**
When the unit’s net worth is eroded or when it becomes sick, it is difficult for it to service the interest of the lenders. At the time of restructuring the debts, the lenders are converting the interest due into FITL or interest proposed to be due in near future is also converted into FITL so that the unit shall have adequate working capital funds available at its disposal.

1.4:9 **Amalgamation of sick unit with healthy unit:**
As a part of the rehabilitation package, when it is difficult to translate negative net worth to positive within a reasonable period of say 5 years or so by sick industrial company, then as a part of restructuring exercise, the said company is being merged either with the healthy unit of the same
management group company or with other group which shall have benefits of set off of losses of the sick industry against the healthy unit and accordingly there is sizeable savings in the taxation resulted in improvement of working of the sick industry.

1.4:10 Sale of excess/non-used assets of the sick industry:

In number of cases lenders are giving permission for sale of excess land or non-used assets such as investments or brands so that sick industry can receive funds for its working capital operations and accordingly sick unit can become a healthier unit.

1.4:11 Change of management:

In spite of number of opportunities given to the present management for conversion of the sick industry into a healthy unit and when no positive responses are received, but there are good chances of rehabilitating the said unit, then lenders are also taking resort for change of management and accordingly under the leadership of new management turnaround is possible.

1.4:12 De-merger of sick industrial undertaking and raise funds for the resultant company:

In case if the sick industry is having more than one undertaking, then it is possible to divest or de-merge one of the undertakings so as to raise adequate funds either in the hands of the promoters or in the hands of the company and reviving the resultant company.

1.4:13 One time settlement (OTS):

Lenders are giving an opportunity to the promoters for entering into OTS and accordingly they are giving waiver of entire interest only or also taking haircut (sacrifice) in the principal amount. Similar treatment is also given by the unsecured creditors or statutory authorities and workers so as to revive the unit. Funds required for working capital are provided either by promoters or strategic investors.
1.4:14 **Capital restructuring by reduction of existing capital and infusion of additional capital by promoters**

When the net worth of the company is eroded, the value of the equity shares of the company is nil or negative and accordingly when strategic investor or the promoter infuses additional funds in the company, the existing capital of the company is reduced by certain percentage so that the additional funds by way of equity is available to promoter/SI at discounted rate without bringing discount in the books of accounts. The existing capital is reduced and new funds brought in by the promoters/SI are issued at par and the promoters holding shall increase to that extent.

1.4:15 **Reduction or waiver of interest/principal by banks/FIs**

When sudden heavy losses are incurred due to external forces and it is difficult for the company to revive of its own then sustainable debt is being worked out and interest applied by banks/FIs is reduced/waived and similarly hair cut (sacrifice) in the principal is also being taken by the banks/FIs of the excess liability over sustainable debt.

1.4:16 **Raising of additional funds by mortgage/pledge of assets/shares of the promoters**

In number of cases, banks and financial institutions are restructuring the debt and offering additional funds to the said company by taking additional security of unencumbered assets of the promoters or pledge of entire shares of the promoters.

1.4:17 **Partial sale of assets/conversion of loan into equity, etc.**

In case of large companies, when it is not possible to adopt any one measure for restructuring of the debt, banks/FIs allow the company to sell part of the unused assets as well as converting part of the loan into equity or preference capital, waiving interest and taking hair cut in the principal as well as allowing the company to take up job work for the idle capacity.
1.4:18 **Providing subsidy by government to sick industry as well as giving priority in government tenders:**

When industrial units become sick and workers engaged by the company are in large numbers, than it can affect the economy of the location. Under this situation, the government is providing subsidy to the specific sick industry as well as giving priority in awarding government tenders of the items manufactured by the sick company.

1.4:19 **Providing additional loan and recovery of old and new loan through cutback system:**

If the lenders finds out that the revival of the sick industry cannot be possible without infusing additional funds and the viability of the project is established and promoters have agreed to infuse their share, then the banks are providing additional funds with a condition to cutback part of the money from the sale proceeds/deposits made by the sick industry in the bank account. From every sale proceeds, some portion is taken by the bank which is known as “Cutback system” and accordingly the said recovered amount is applied towards principal/interest.
1.5 LAWS DEALING WITH INSOLVENCY/ FINANCIAL RESTRUCTURING IN INDIA

Laws which shall prevent insolvency in the country and resulting into financial restructuring are classified as under:

1. Companies Act, 1956 (Section 391 to 396)

2. Sick Industrial Companies (Special Provisions) Act, 1985 (SICA Act)

3. Corporate Debt Restructuring Scheme (CDRS) under the aegis of Reserve Bank of India, RBI guidelines during special circumstances or on special mentioned accounts.
