PERIODICA POLYTECHNICA SER. SOC. MAN. SCI. VOL. 6, NO. 1, PP. 67–76 (1998)

FINANCIAL CONDITIONS OF ENTERPRISE RESTRUCTURING

Márta SZABÓ

Department of Economics
Technical University of Budapest
H–1521 Budapest, Hungary
Phone: 36 (1) 463 1396
Fax: 36 (1) 463 1906

Received: Febr. 1, 1998

Abstract

The first part of the study gives a review of the overall performance of the Hungarian industry in the late 1990's. The overall figures are favourable, but the output and export growth rate data indicate wide variations by ownership structure of companies. The study separates categories of companies by dynamism of restructuring, analyses the reasons, why the foreign ownership is contributing to the quick recovery. The second part of the study analyses the present state of the financial processes of companies, focusing on cash management, capital structure and divided policy of the small and medium size companies.

Keywords: company restructuring, ownership structure, financial management.

1. Industrial Performance

Since 1990 most of the Hungarian companies were confronted by the necessity of restructuring, deriving from both domestic and external considerations. Domestically, because after the first democratic election the government has declared to introduce a Western-type market economy. Externally, because enterprises confronted liberalized international trade with West from 1991, when the trade and payment system of former socialist countries collapsed. After multidimensional crisis Hungarian companies are on the way of recovering. In 1997 the output increased more than 9 per cent, the exports were 20 per cent higher than a year before. The dynamic development is based on the export performance. The overall figures of industry are favourable, but the output and export growth rates indicate wide variations by industrial branches and by ownership structure.

Some subsectors of manufacturing indicate high performance figures. The output and export productions increased especially in the paper, publishing and machinery subsectors (*Table 1*). More than 70 per cent increase in the machinery and equipment's export is impressive. The other fields of the industrial production have not reached the same development. The recovery of construction, transportation sectors and agriculture is postponed.

Table 1. Output and export by industrial subsectors

Sector	Output % 1997/96 (Jan-Sept.)	Export % 1997/96 (Jan-Sept)	Foreign ownership in subscribed capital (1995)
Food, beverages, tobacco products	93.1	103.1	78.6
Textiles	101.3	101.6	83.8
Wood, paper, printing products, publishing	112.3	130.7	84.4
Chemical industry	105.0	106.7	52.6
Metallurgy, metal products	105.4	112.8	70.3
Machinery, equipment's	154.0	177.7	80.1

Source: Calculated from Yearbooks of Central Statistical Office, 1997, 1996.

What is the reason, why some companies could develop better than others? Among several reasons, the most important is the way of company restructuring. The former state owned companies required a transformation from old to new activities and change of ownership structure.

The locomotive sectors of the Hungarian economy undertake a great deal of restructuring. The data of ownership (*Table 1*) reflect a radical ownership change, comparing the dominance of the state ownership of a decade before. In the successful sectors the proportion of foreign ownership exceeds 80 per cent, measuring by the subscribed capital (the industrial average is about 45% in 1996). The foreign ownership could manage the full restructuring of companies within a short period. Restructuring requires large capital expenditures. The capital equipments of state firms were technologically obsolete. The foreign owners financed the technical and technological changes. (The direct foreign investment was higher than a billion dollar in Hungary per year). The quick capital injection is one of the reasons why the joint venture companies provide better performance. Renewing the technology is important, but the less successful companies have to learn more of economic processes of joint ventures.

More knowledge and experience is required on the field of:

- product management
- sales management
- financial management

Of course the technical development plays the most important role, as the sector of machinery production proved. However, the outdated technology is not the only factor of low efficiency. The improper use of machinery, the unefficient organization of working processes contribute to slow down the transition of companies. Demanding much care about working processes is the first step in transition. Adapting higher management standards, likely is the second step to improve productivity, to produce higher value added production.

In the next part I analyse which companies need to speed up restructuring and the financial management is the special aspect for further analysis.

2. Groups of Companies by Dynamism of Restructuring

In the Hungarian economy three different groups could be separated by the way and speed of restructuring.

1. Dynamic companies
2. Passive companies
3. Newly established companies

2.1. Dynamic Group

Companies belonging to the dynamic group play the role of tractive force, the locomotive in the economy. There is no appropriate method for separate companies among three categories, but the ownership helps in many cases. Which companies are regarded as dynamic ones?

- Affiliates of large multinational firms,
- Joint ventures companies with significant foreign capital contribution,
- A few privatized, transformed firms, with Hungarian private owner.

From the beginning of the political and economic transformation of the country, the large multinational firms are present and their activity has a great impact on the economy. Geographical position of Hungary offers them *bridge* to West and East, the size of Hungarian market and wage consideration has less effect on their investment.

The increasing gross profit margins figures (sales/earnings before tax) indicate the dynamism of the affiliate companies (*Table 2*).

Most of the joint venture companies were established by Hungarians, lived long abroad or the former working connections continued as joint ventures. In the top list of Hungarian firms (TOP 200) more than half are owned by foreigners and around 50 per cent of GDP is produced by the firms with foreign participation.

A few Hungarian owned companies can be characterised as dynamic. During the first phase of privatization some talented managers could accumulate large capital and they could manage and develop their firms in

Table 2. Gross profit margin of some manufacturing companies (%)

Company	Sales / EBT, 1996	Sales / EBT, 1995
Opel Hungary	18.2	14.3
GE Tungsram	34.2	24.1
Suzuki Hungary	1.5	(0.9)
Audi Hungarian	8.1	10.1
IR3 Video (Phillips)	0.7	(6.9)

EBT: Earnings before tax

Source: Calculated from data Figyelő 1997, July 24.

the difficult periods of transition. These managers – owners are not only talented, but have a good business experience on business as well, some of them had a successful private business in the socialism, some of them proved their ability as top managers in the state firms or in the state bureaucracy. What are the key factors of the dynamism, which are worth to adapt by other companies?

2.1.1. Facing to Market

They prepared their plan, strategy, production, etc. matching the market requirement. This factor seems quite trivial but not so evident for the former state owned companies.

2.1.2. Orientation for Future

The dynamic firms look always one-, two years forward, they treat the problems from the aspect of future, they are a step before their competitors.

2.1.3. Continuous Adjustment

When the outside or inside conditions, environment change they make adjustment for the new conditions. They do not wait for the next opportunity. Hungarian owned medium size companies are often waiting for a stable period, they have to learn how to plan and work in the changing world.

2.2. Passive Groups

Many medium size (and some large) companies struggle and fight for survival. They are mainly privatized firms and during the privatization their shares were bought by former managers, workers or were sold in the auction to the Hungarian private investors. The investors had enough capital for buying the undervalued shares, but have no capital to invest more into the company. Financing current assets, changing machinery, hiring the skilled workers all need capital. These companies used net profit (retained earnings) for paying back the loans, inherited from the former state firms. They are in the financial trap: they have no profit to finance restructuring and they cannot acquire credit until they do not pay back the former bank loans. Companies in the passive group work in the threatened climate. The decreasing sales, profit, press them to work harder, but usually the managers follow the same track. Can they get out from the crisis? The only way for recovering is to introduce an entirely new way of managing the companies, mostly replacing the management, adapting new financial, production and marketing methods.

There is no sufficient reliable statistical data about economic activity of the medium size firms, however, more and more news is about financial difficulties of these companies. In the next few years many of them will be acquired by large multinational firms. They can continue their activity if they renew all the processes of production. The possible market for these companies mainly is the domestic market and subcontracted market, providing spare parts for large firms.

2.3. Newly Established Companies

Number of new companies increased quickly in the early 90ies, by now their number stabilized. Most of the newly established companies are small, as far as sales or number of employees. In many cases the new firms are not real business enterprises. These are workplaces, utilise their own manpower. These firms have poor capital, business experiences. They provide services in the local area. A very few of them can develop into medium size firms, their growth potential is too small.

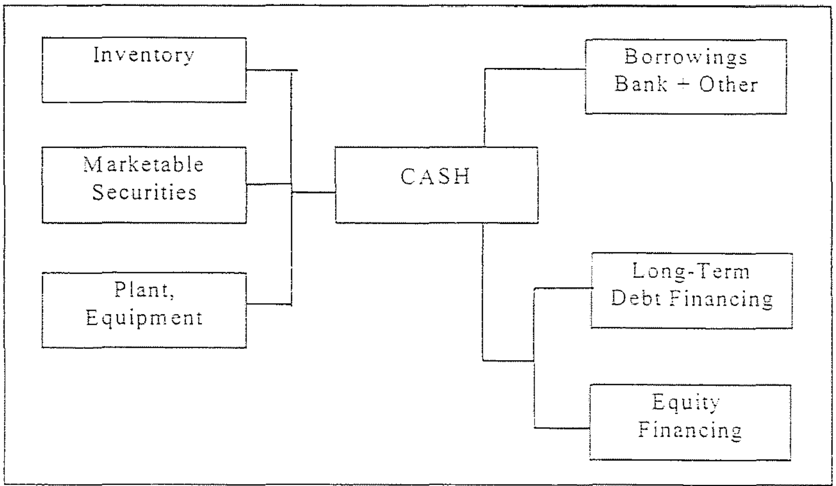
To improve their performance it is also important to adapt the Western standards of managing the firm.

Companies of *passive* and *new* groups need to adapt and renew the production management. Further on I analyse the financial position and financial management of these groups' firms.

3. Development of Financial Management

In the 1990's the financial management is different even in the Western countries than it was a decade before. Many new issues have appeared, such as portfolio management, warrants, costs of capital. Managers and owners of Hungarian small and medium sized companies (passive and new companies) are on the way of learning or adapting the modern financial methods. These companies have not enough experiences how to separate the double aspect (the investment and financial aspect) of business and they are not familiar with the key role of cash management in the business circle. The *Table 3* shows the complexity of the financial management.

Table 3. Short-term and long-term financial management activities



Generally, the Hungarian managers are unfamiliar with the central issue of financial management with the cash management. Financing of fixed assets, in inventories has some new elements, but not unfamiliar for the leaders of the companies. Many new questions arise about equity financing, cost of capital, financial leverage. The small businesses, which have no management experience, sometimes have difficulties in solving the basic financial problems, they cannot separate clearly the investment and financial decisions. Among several problems I focus on some important parts of financial decision making processes.

The next questions will be examined:

- state of cash management
- capital structure and leverage
- dividend policy

4. State of Cash Management

Planning for and controlling the use of cash are important tasks in the companies. A firm can be profitable according to the reported earnings and still go bankrupt because of a lack of cash. The medium sized and small companies in the course of daily operation make an effort to keep hand cash circulation. The former state owned companies treat cash management importance in different way.

4.1. Cash Management in the Passive Group

Managers of the former state companies get used to an easy financing in the late period of socialism. The quantitative fulfillment of production had been preferred within the performance of company, finance was in the subordinate position. The financing sources of current assets was lack from the equity capital, and had been financed continually by short term bank loans. Collapsing their former foreign and domestic market, the rapid increase of debt service became the main problem of these companies.

The high debt service reduced not only the profit (measured by earnings before tax, EBT), but has been supplemented by inadequate attitudes of managers, they have not applied *active* cash management function until now.

The cash management activity refers to a combination of activities, such as cash flow management, cash forecast, investing excess of cash.

Why have the companies not realised the importance of cash management? One of the most important reasons is the weak informational background about sales, production costs, etc. The companies do not know the costs of a certain production or the actual position of cash collecting. Without correct information the management cannot keep tight on cash disbursement, collection and cannot exploit the advantages of short term cash borrowing/lending. By now companies are on the way to apply computer softwares to set up a proper information system.

Some necessary adjustment of cash management in the passive group:

- tight control of cash collection and disbursement, analyze the financial risk of cash receivable
- investing the excess cash immediately, learning the methods of short term investments.

4.2. Cash Management in New Firms

In the small businesses the cash is in the key post, the cash keeping is generally overvalued. The tight cash management is characterized by the cash collecting and disbursement processes. In the trade transactions the cash transfer is preferred instead of transfer through banks. Cash use in transactions has many negative effects on macroeconomic processes, among them:

- cash transfer, without invoices, increases the black and grey economy
- less bank transfer allows less effect of monetary policy.

The second area of financial questions of small businesses is lack of double approach of financing, the investment and financial side of the capital has not been separated. The small firms' owners treat the financial processes of firm such as in the households, the cash in the cash box is often treated as a profit. It is necessary to go beyond this approach and separate the different forms, the assets and equity forms of capital.

The next step for the small firms would be to extend the tight cash management to the field of managing excess money and obtain gains from changes of interest rates and price of securities.

Nowadays investment excess cash effectively requires too much effort to small businesses, which keeps their attention on maintaining the business.

5. Capital Structure and Leverage

The capital structure refers here to the long term sources of financing. As we can see from *Table 3*, this primarily involves long term debt and equity financing. In choosing among capital structures the firms encounter the all trade off between return and risk. The long term debt financing generally has lower cost of capital than equity financing, but in the transitory economies the high interest on debt causes lower proportion of long term debt. The high interest rate is the outcome of the financial market's instability, especially caused by bad portfolio of banks and the crowding out effects of government.

The *Table 4* contains the ratios of capital structure of some large Hungarian companies from dynamic group. The ratio long term debt to owners equity reflects the same picture in every company, the low level of outside capital. When the level of outside capital is too low, the company does not exploit the tax reduction effect of debt (via calculating interest as cost), there is no space for forming actively the firm's capital structure. The low proportion of long term debt in the capital structure is the consequence of the critical stage of financial markets. The other groups, the passive and the new companies, keep more strict financial policy in the field of long term financing, generally they use only retained earnings for financing investments.

Table 4. Financial ratios of some public shared companiesDecember 31, 1997 %

Firm	Retained earnings/ Earnings after tax	Long term debt/ Owner's equity
EGIS	88.8*	5.7
MOL	71.8	43.3
BORSODCHEM	100.0*	2.4
GRABOPLAST	56.5*	0.7
PICK	80.6*	8.4
RABA	100.0	1.4

* 1996

Source: Calculated from data Figyelő, February 19. 1998.

6. Dividend Policy

The dividend policy and capital structure are closely related to the firm's future development.

Dividends allow the owner to receive value directly from the firm. The concept of dividend is used here as any direct payment by the firm to the owners whether in cash or in property of any kind. The cash dividend payments are only part of the dividend distribution to the owners. The primary forms of dividend in the transitory economies are as follows:

- cash dividend
- cash financed acquisition
- dividend in kind

Cash dividend is taxed twice (first at a corporate level, second at the personal level), the medium sized and small companies make several efforts to avoid double taxation, in order the manager/owners withdraw the profit in kind. The life insurance paid for managers, firm's car for private use, etc. are not only the part of manager's incentive package, but play important role of cost reduction, and the form of withdrawing profit before taxation.

The acquisition in the dynamic group, the typical characteristic of dividend is the acquisition. The large companies acquire new factories, shares in the form of financial investment. The late 1990s are the years of quick accumulation, and the sources of the accumulation are mainly the dividends as a form of financial acquisition.

Table 4 contains ratios of retained earnings to earnings after tax. The high level of these ratios means that only 20–30 per cent of earnings after tax is paid as cash dividend. The 60–80 per cent of earnings after tax is used as financial sources of investment. The managers/owners prefer low cash dividend payout, it is characterised not only by the large, but medium size companies as well. The dividend policy in the dynamic and partly in the passive groups is influenced mainly by the firm's investment needs and opportunities.

The increasing effort of managers/owners in the field of financing would contribute to the transformation of Hungarian companies.

References

[1] BLOCK, S. T. – HIRT, G. A.: Foundations of Financial Management, Irwin, sixth edition.
[2] Stock Exchange Supplement. *Figyelő*, 19 February, 1998., 24 July, 1997.
[3] SZONYI, A.: Small Business Management, Park Kiadó, 1990.
[4] IRWIN, D.: Cash Management, Readers International, 1991.