Mardumyan M.S., Yeghiazaryan A.S.

VALUATION OF DISTRESSED COMPANIES IN POST-TRANSITION ECONOMIES

Mardumyan M.S., Armenia, Armenian State University of Economics, acting Head of Chair, PhD in Economics, Associate Professor
Yeghiazaryan A.S., Armenia, Armenian State University of Economics, Assistant Lecturer, PhD in Economics

Abstract
In developed countries with large stock markets and an active business environment business valuation methods are already advanced and have been widely discussed. This paper discusses the valuation of distressed and politically connected companies in post-transition economies. We define all types of politically connected firms.
Keywords: Failure, assessment, politically connected firms, viability.

Valuing distressed companies is important for all economies but is significant for transition or post-transition economies because the business environment is more turbulent, which increases the probability of entrepreneurial failure [1]. Highly visible and publicised success stories of entrepreneurship hide a much longer list of less documented failures. Failed entrepreneurs may become ‘serial entrepreneurs’ and start a new enterprise, or decide to abandon this activity and go back into the regular labour market [2].

Returning to the labour market requires the remaining business to be valued before further decisions are made to allow the effective reallocation of resources throughout the economy and help other companies avoid going down the same path.

Valuing distressed companies requires an understanding of their viability [3]. When it’s assets are worth more than its business, they are sold separately and the company is not viable; in other words, it is economically distressed.

When a company cannot pay its debts, but it works as a business with opportunities to continue after financial rehabilitation, it is also economically distressed. Valuing financially distressed companies includes considering new

management and new strategic and development programmes, which is important, because during valuation we appreciate the future, not the past.

The going-concern value may be greater than the market value (and therefore, it has greater value than liquidation value) because a living business – with established customers, knowledgeable employees, and so forth – may well bring a higher price as a unit than if each of its assets were sold separately, even in the unlikely event of those separate sales achieving market value' [4]. For small businesses the difference between value, market value and liquidation values could be a few thousand dollars, whereas larger businesses could lose greater amounts.

Many failed companies fit the two classical types of economic distress described, but there are other companies that are viable and can pay all their debts which operate in a normal economic environment but bring in zero or insufficient profit. This is another type of entrepreneurial failure because going into business you expect it to be profitable. The main reason for this failure is inequality of economic subjects where some business leaders in that sector have opportunities connected with political power, which causes an unequal business environment for others. So, when small or medium businesses are taxed and pay other charges there is nothing left for profit, which is why in some sectors the shadow is developing.

For entrepreneurial failure, we can classify businesses into two main types: small and large. For small businesses, there are variety of natural reasons leading to failure including, lack of industry experience, inadequate financing, lack of adequate cash flow, poor business planning, management incompetence, ignoring the competition etc. These are the main reasons for small business failure [5]. The influence of the business environment is not discussed for small businesses, because it is more amenable to external factors. But large businesses are more vulnerable to political change, particularly in those countries where they report directly to politicians. In some countries government regulations, neoliberal economic policies and development logic influence the operation and appearance of the business [6].

The type of ownership influences the value of a business. There are many reasons for valuing a business, but the main one is for buying and selling which is why when estimating the value, we must be sure that the existing business processes are viable after a change in ownership.

There is a lot of debate about the advantages of firms connected with politicians, when in fact, evidence from France shows that connected firms have lower profits than unconnected firms [7]. For post-soviet countries, this pattern is different, but in future this is likely to change in all countries, because any business incubators will succeed if conditions remain unchanged.

Using income valuation methods, it is important that cash inflows and outflows can be predicted and will continue. Politically connected firms will be discussed separately.

First, there are firms that receive all cash inflows from one source. These businesses are worthless for new owners, because after a while the cash inflows disappear. Usually in this situation the firms are not viable in market conditions. Such companies are interesting for their equipment at market liquidation prices and concurrent and substituting firms might find some business value in them connected with business processes and employees.

Second, this group is like the first group, but receives part of their cash inflows from the market, which are more competitive and viable without political assistance if the market part of the inflows is large enough. The value of these companies is correlated with the market portion of the business: the value of the business is as large as the market portion.

Third, in this group, companies have sponsorship for their financial outflows, such as taxation, free marketing services, municipal fees, debt financing etc. [8]. If this group brings cash inflows from the market, without political sponsorship the costs would rise and the net cash flow would fall. Regarding prices, if the company operates in a market with low non-competitive prices, after losing sponsorship it would have higher prices and share its existing clients with concurrent and new established companies. So, these companies also have little business value. But if they operate in competitive markets with equilibrium in prices, we could value them taking account of the costs that have not been paid.

Fourth, is the combined politically connected group where business managers do everything to increase sales and minimise costs and owners take every opportunity to sponsor connected companies (here we mean all types of sponsorships as previously discussed). In these cases, the valuations are more difficult, but if we understand the value drivers we can use the appropriate valuation methods.

Politicians are willing to use their political power on future businesses. When a business owner has political power the value of the firm is increased. A fair valuation process examines a firm's ability to generate cash flows for its founders based on objective facts. It is not usually possible to establish a firm's value based on its owners which is why during valuation we assess the actual financial flows including any risks related to the forecasting of future flows, which could include a change in ownership.

Almost all valuation methods include risk measurement. Discounting models use growth rates and beta coefficients and growth rate assessment includes future risks and opportunities. The chance of losing cash inflows would negatively affect the growth rate which is one way of calculating risk impact. Estimating earnings growth rate is also problematic, whether one uses historical growth, analyst projections or fundamentals. Estimating historical growth when current earnings are negative is difficult and the numbers, even if estimated, are often meaningless [9]. This problem could be solved with fundamental analysis using econometric models. The model's independent

variables are value drivers and fundamental factors and the dependent variable is growth rate. There are taxation problems with distressed companies because tax costs are included in cash flows. Going concerns pay taxes for earnings, but they do not receive cash inflows for negative earnings. Thus, when valuing firms, we discuss the life of the problems; are they short term temporary problems, or long term systemic ones?

The second way of entering risk in discounting models is by using beta coefficients to measure the correlation of the firm's market profitability and reveal the extent of systematic risk in that business.

Many economic analysis teams ascribe a medium level of political risk to the economy of Armenia [10]. This increases the risks for all businesses and affects their value.

Conclusion

In post-transition economies when valuing a business, we would define its connections with the political powers. There are four types of political assistance; providing cash inflows, help in market competition, decreasing cash outflows and mixed. All of them require a special approach during valuation to calculate the changes to inflows and outflows that would occur if there was no political support, and it is likely that in some cases, these businesses would not be valuable at all. For other firms, we would estimate their share of market consumption. These approaches are also useful for foreign direct investments.

References:

[1] Mardumyan M. S., Entrepreneurial failure in turbulent business environment, №7/2017, Znanstvena misel journal, Slovenia., pp. 5-8.
[2] Canidio A., Legros P., The Value of Entrepreneurial Failures: Task Allocation and Career Concerns. Department of Economics, Central European University, May 20, 2015.
[3] Rizwaan J. M., Corporate Insolvency Law – Theory and Application (Oxford: Oxford University Press, 2005), 194-195.
[4] Westbrook J., The Control of Wealth in Bankruptcy, (2004) 82(4) Texas LR 795, 811.
[5] Titus S., Key Reasons Why Small Businesses Fail, Accredited Associate of The Institute for Independent Businesses.
[6] Gerring J., Thacker S. C., Do Neoliberal Economic Policies Kill or Save Lives?, Business and Politics, Volume 10, Issue 3, Article 3, Boston University, 2008.
[7] Bertrand M., Kramarz F., Schoar A., Thesmar D.,Firms and the Political Business Cycle: Evidence from France, University of Chicago, Graduate School of Business, March 15, 2007.

[8] Faccio M., R. Masulis W., McConnel J. J., Political Connections and Corporate Bailouts, The Journal of Finance, Vol. Lxi, No. 6, December 2006.
[9] Damodaran A., Investment Valuation, New York Stern University, Wiley Finance, 2012, pp. 211-220.
[10] The Global Economy, http://www.theglobaleconomy.com/Armenia/political_risk_short_term.