Exploring the indirect costs of a firm in business rescue

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Abstract

It may be argued that the indirect costs of financial distress are substantially higher than the direct costs. Consequently, indirect costs of participating in a formal turnaround may hinder the success of a reorganisation attempt. This study set out to explore the indirect costs financially distressed firms face as a consequence of participating in business rescue in South Africa. Due to the implicit nature of these costs, the focus was placed on investigating and identifying the sources of the indirect costs associated with business rescue. This study employed a qualitative research design, whereby semi-structured interviews were conducted with 13 business rescue practitioners. The study confirmed that firms may experience six difficulties during business rescue. However, there are several factors that influence the severity of these difficulties. Conversely, it appears that indirect costs may also offer firms several benefits. The results of the study may assist affected parties, as they offer some insight and clarity on the indirect costs of business rescue. Understanding indirect costs may assist stakeholders involved in the process to find strategies that will help to preserve the value of the firm and reduce the negative impact for all stakeholders involved.

Keywords: financial distress; insolvency; reorganisation; business rescue; indirect costs; South Africa

Pessimism is not only unwarranted, it is also a self-fulfilling prophecy. If you think the cause is lost, it will be. No one works hard for a cause they think will lose. – Lawrence Reed

Introduction

Firms that enter business rescue proceedings may inadvertently bring upon themselves a negative perception purely through the act of applying for business rescue. This negative perception as a "self-fulfilling prophecy" may contribute to the failure of any rescue attempt before it even starts. This reputational damage has the potential for a series of follow-on effects (Bhabra & Yao, 2011, p. 46; Searle, 2013, p. 19). The stigma associated with reorganisation procedures such as business rescue may cause key stakeholders to withdraw from the firm. Consequently, suppliers may transact on adverse terms to reduce their risk exposure; credit facilities and overdrafts may be cancelled; customers may reduce risk by searching for alternative suppliers; and employees may fear retrenchments, which may cause a loss in morale, which subsequently leads to lower productivity and increased employee turnover (Bhabra & Yao, 2011, p. 46; Loubser, 2010, p. 504; Sutton & Callahan, 1987, p. 405). These suboptimal actions by the firm's stakeholders may result in lost sales and lost opportunities for the firm (Senbet & Seward, 1995, p. 924). These costs, among others, are referred to as indirect costs of financial distress. Indirect costs are not actually paid out as expenses, but rather arise in the form of lost opportunities and lost profits that result from a loss of customer and supplier goodwill, a decrease in employee morale and productivity, a loss of key employees and management, the inability to raise finance, and inefficient asset sales (Altman, 1984, p. 1071; Andrade & Kaplan, 1998, p. 1445; Armour, Hsu, & Walters, 2012, p. 110; Bhabra & Yao, 2011, p. 45; Chen & Merville, 1999, p. 277; Pulvino, 1998, p. 940).

The above indirect costs may cause an even faster deterioration of the operating performance of a firm that is already in financial distress; as a result, indirect costs may impede the success of the rescue attempt (Searle, 2013, p. 19). It is often argued that indirect costs of financial distress are substantially higher than direct costs (Bisogno & De Luca, 2012, p. 22; Chen & Merville, 1999, p. 277). Understanding the indirect costs of business rescue is imperative; firms and business rescue practitioners (BRPs) need to take these costs into account during proceedings. However, as far as could be determined, there is a gap in South African literature regarding what the indirect costs of business rescue proceedings are. Therefore, the purpose of this study was to explore the indirect costs financially distressed firms face as a consequence of participating in business rescue proceedings in South Africa, and in so doing address this gap and assist in future research.

This study aimed to answer what indirect costs firms experience while undergoing business rescue proceedings in South Africa. However, the nature of indirect costs makes them notoriously difficult to study. Therefore the focus was specifically placed on investigating and identifying the sources of indirect costs associated with business rescue. Since such costs are unobservable in nature and are therefore difficult to specify and empirically measure, the research question was extrapolated to focus on and investigate six important sources of indirect costs identified in the literature. The specific questions that were answered through this research study were extended to include the following:

- Do firms experience a loss of customer goodwill during business rescue?
- Do firms experience a loss of supplier goodwill during business rescue?
- Do firms experience a decrease in employee morale and productivity during business rescue?
- Do firms experience a high turnover of key employees and management during business rescue?
- Do firms face challenges in raising finance during business rescue?
- Do firms sell assets at depressed prices during business rescue?

A literature review from which these specific questions emerged is presented next. Thereafter, the findings of this study will indicate the extent to which these sources of indirect costs are prevalent within the business rescue process.

Literature review

Financially distressed firms have two distinct formal insolvency procedures to deal with: liquidation or reorganisation. Liquidation proceedings consist of stripping the firm of its assets and all claims against the firm are settled (White, 1989, p. 130). In contrast, reorganisation seeks to take advantage of the reality that in many cases a firm not only has substantial value as a going concern, but its going concern value exceeds its liquidation value (Smits, 1999, p. 86). Reorganisation procedures provide financially distressed firms with an opportunity to be rescued and avoid foreclosure, and to rather continue as commercially viable entities contributing to economic growth. The core purpose of a reorganisation is to prevent unnecessary liquidation of firms and to preserve jobs (Loubser, 2013, p. 450; United Nations Commission on International Trade Law, 2005, p. 209).

In South Africa, the reorganisation process is known as business rescue, presented in Chapter 6 of the Companies Act No. 71 of 2008 (“the Act”). The Act defines a firm as financially distressed when it appears reasonably unlikely that the firm will be able to pay its debts within six months of when its debts are due and payable, or when it appears reasonably likely that the firm will become insolvent within the next six months. This is well aligned with a fairly international definition presented by Wruck (1990) as “a situation where cash flow is insufficient to cover current obligations. These obligations can include unpaid debts to suppliers and employees, actual or potential damages from litigation and missed principal or interest payments”.

A firm that is financially distressed may choose protection under a reorganisation procedure should it believe there exists a reasonable prospect of its survival. Reorganisation proceedings such as business rescue are, however, particularly expensive, as additional costs are encountered (Francis & Desai, 2005, p. 1204). For this reason, the costs associated with insolvency proceedings play an important role in a firm’s choice between liquidation and reorganisation (White, 1989, p. 146). The literature typically divides these costs into direct and indirect costs. Direct costs can be defined as the transaction costs (the out-of-pocket expenses) that are directly related to administering insolvency proceedings (Altman & Hotchkiss, 2006, p. 93). Direct costs include administration costs such as filing expenses and fees paid to professionals such as lawyers, accountants, business consultants, turnaround specialists and various other professionals (Altman & Hotchkiss, 2006, p. 93; Armour et al., 2012, p. 109; Bhabra & Yao, 2011, p. 43).

The indirect costs of financial distress are, on the other hand, those not actually paid out as expenses during insolvency proceedings (Armour et al., 2012, p. 110). Indirect costs are the hidden losses that are a consequence of operating a firm that is unable to meet its financial obligations (Farooq & Jibran, 2018, p. 112; Pindado & Rodrigues, 2005, p. 345). These costs are difficult to specify and measure empirically. As a result, indirect costs are often overlooked when considering the impact of insolvency proceedings on the firm (Altman, 1984, p. 1068; Bisogno & De Luca, 2012, p. 22; Kwansa & Cho, 1995, p. 342). According to Farooq and Jibran (2018), the literature provides a variety of definitions and proxies for the indirect costs of financial distress. The most widely studied proxies of indirect costs are lost opportunities and lost profits (Altman, 1984; Bisogno & De Luca, 2012; Kwansa & Cho, 1995; Molina & Preve, 2012; Opler & Titman, 1994; Pham & Chow, 1989; Wijantini, 2007). Lost opportunities are typically measured as the difference between the industry sales growth and the firm’s sales growth. Similarly, lost profits are calculated as the difference between the industry’s operating profit margin and the operating profit margin of the firm (Farooq & Jibran, 2018, p. 120).

For the purposes of this study, indirect costs will be defined as lost opportunities or lost profits that result from a loss of customer and supplier goodwill, a decrease in employee morale and productivity, a loss of key employees and management, the inability to raise finance and inefficient asset sales (Altman, 1984, p. 1071; Andrade & Kaplan, 1998, p. 1445; Bhabra & Yao, 2011, p. 45; Chen & Merville, 1999, p. 277; Pulvino, 1998, p. 940). Indirect costs are not limited to firms that file for a formal reorganisation procedure. However, indirect costs associated with financial distress may be amplified in formal reorganisation proceedings (Campbell, 1997, p. 22; Chen & Merville, 1999, p. 277).

Owing to the stigma associated with reorganisation procedures, firms may experience reputational damage when entering such a procedure (Sutton & Callahan, 1987, p. 405). As a result, it can be argued that the magnitude of these indirect costs may be greater when a firm enters a formal reorganisation procedure. When a firm experiences financial distress, these issues can often be concealed from various stakeholders, as there is an asymmetric availability of information amongst various stakeholders. However, when a firm files for proceedings, key stakeholders are usually informed and are privy to the business rescue plan when published, and thus private information is made available to various stakeholders and possibly the public (Rosslyn-Smith & Pretorius, 2018, p. 89). Access to this private information may adversely alter stakeholder's behaviour towards the distressed firm (Sutton & Callahan, 1987, p. 412). This behavioural shift is likely to be motivated by various influencing factors that fuel the sources of indirect costs that are presented in Figure 2. To understand how prevalent these costs are in business rescue, we investigate their sources individually.

Loss of customer goodwill

One of the biggest challenges financially distressed firms face may be to persuade its existing customers to continue doing business with the firm. Customers may shift purchases to alternative suppliers as they may fear that product quality or that continuity of supply may be compromised (Hertzel, Li, Officer & Rodgers, 2008, p. 375; Liou & Smith, 2007, p. 89; Sautner & Vladimirov, 2017, p. 1). As customers start withdrawing from the firm, the firm may experience a decrease in sales. The drop in demand harms the firm's profitability, exacerbating its financial distress (Bisogno & De Luca, 2012, p. 23; Hortaçsu, Matvos, Syverson & Venkataraman, 2013, p. 1249; Sautner & Vladimirov, 2017, p. 1).

The degree to which a firm experiences a loss of customer goodwill may be influenced by several factors. Firms with high asset intangibility may experience a higher sales loss, as they are typically vested in patents, trademarks and a good reputation, and provide after-sales services. Under financial distress, customers may be more hesitant to buy the products of a firm with high asset intangibility (Bulot, Salamudin & Aziz, 2017, p. 13). For example, car manufacturers offer goods and services that complement its core product, such as guarantees and warranties, spare parts, maintenance, and upgrades. Customers who fear the loss of these valued amenities may be less willing to pay for the firm's core product (Hortaçsu et al., 2013, p. 1249; Tajti, 2017, p. 10). Knowledge of the firm's financial distress may lead competitors to take advantage of the distressed firm's weaknesses, by using aggressive marketing strategies to capture its market share. This is especially prevalent in concentrated industries (Farooq & Jibran, 2018, p. 120).

Customers' reaction to a firm in financial distress will depend mostly on the type of relationship they have with the firm and the cost of finding an alternative supplier. In situations where customers have an arm's-length relationship with the firm, and low or no switching costs, customers tend to switch to alternative suppliers to mitigate their risk. In other cases, where the customer is purchasing unique products or purchasing products with few good substitutes, switching costs may be high (Banerjee, Dasgupta & Kim, 2008, p. 2507; Bode, Hübner & Wagner, 2014, p. 32-33; Hertzel et al., 2008, p. 383; Lian, 2017, p. 399).

In addition to a reduction in the firm's demand, customers may also behave in ways that cause the distressed firm to lose money, even for goods that were already sold. For example, customers are able to negotiate lower prices, and collecting trade receivables may become more difficult and more time consuming for the firm (Sutton & Callahan, 1987, p. 416; Tajti, 2017, p. 10).

Loss of supplier goodwill

The loss of supplier goodwill is often cited as a source of indirect costs faced by financially distressed firms (Hertzel et al., 2008, p. 375; Sautner & Vladimirov, 2017, p. 1). Suppliers may be reluctant to continue to sell to the distressed firm and, as a result, may enforce considerable restrictions and higher costs upon it. Suppliers may impose costs on distressed firms by failing to supply trade credit and demanding cash-on-delivery (COD) for goods supplied (Altman, 1984, p. 1072; Loubser, 2010, p. 504; Pretorius, 2015, p. 65). The loss of trade credit may further exacerbate the firm’s problems, as it is often an important source of short-term finance for distressed firms. A loss of trade credit places extended pressure on a firm’s immediate cash flow, which in turn will hamper turnaround efforts (Bisogno & De Luca, 2012, p. 23; Molina & Preve, 2012, p. 187; Pretorius, 2015, p. 65).

Distressed firms may face several other difficulties with suppliers, such as suppliers delaying shipments, refraining from long-term contracts, withdrawing consignment stock, demanding immediate payment of their claims, or raising the price of goods and services (Altman, 1984, p. 1072; Hertzel et al., 2008, p. 375; Loubser, 2010, p. 504; Pretorius, 2015, p. 65; Sutton & Callahan, 1987, p. 417). The study conducted by Sutton and Callahan (1987, p. 416) highlighted the fact that once firms filed for reorganisation, the quality of goods sent from suppliers often deteriorated.

Although distressed firms may experience difficulties with suppliers, there are several factors that may influence the *degree* to which they experience difficulties. Suppliers who face high switching costs may be dependent on the distressed firm. The supplier may then grant concessions to the firm in order to reduce the risk of failure (Lian, 2017, p. 399; Yang, Birge & Parker, 2015, p. 2320). The failure of major customers might decrease the future demands on the products and services from suppliers, which might lower the supplier's future earnings, thereby increasing the suppliers’ risk of default (Lian, 2017, p. 398). Thus, a supplier’s fear of losing a major sales channel might trigger a “bail-out effect”, where the supplier grants concessions to the distressed firm by offering trade credit and acting as liquidity providers to their important customers in distress (Oliveira, Kadapakkam & Beyhaghi, 2017, p. 148; Yang et al., 2015, p. 2334).

The ability to maintain supplier goodwill may be influenced by management’s ability to maintain the supplier's support and management behaviour, especially in the run-up to the filing for reorganisation (Cook & Pond, 2006, p. 28; Sutton & Callahan, 1987, p. 412). Management may have eroded relationships with suppliers by failing to make promised payments. Thus, Sutton and Callahan (1987, p. 406) indicate that if suppliers do not perceive management as credible, their faith in the firm may be eroded.

Decreased employee morale and productivity

When a firm is in financial distress, the retrenchment of employees, also referred to as downsizing, is regarded as a popular turnaround practice. This practice is undertaken primarily as a cost-cutting strategy to improve cash flows (Smith, Wright & Huo, 2008, p. 73; Smith & Graves, 2005, p. 307; Trevor & Nyberg, 2008, p. 259). The allure of retrenching employees as a turnaround practice is driven by the potential to yield substantial savings in direct employment costs (Chadwick, Hunter & Walston, 2004, p. 406). This presumption, however, may be offset by the hidden costs associated with a decrease in employee morale and productivity, the erosion of trust between staff and management, increased absenteeism, and unanticipated increases in voluntary turnover. It is argued that these hidden costs may well be greater than what is saved from the retrenchment (Smith & Graves, 2005, p. 307; Trevor & Nyberg, 2008, p. 272; Vollmann & Brazas, 1993, p. 21). Another cost-cutting strategy used by distressed firms is cutting employees’ pay in order to save jobs. However, employees resent pay cuts; they may affect their morale and productivity in the workplace (Bar-Or, 2009, p. 15; Bewley, 1998, p. 459).

This loss of employee morale and productivity may have damaging effects on a firm’s attempts to improve, and could severely impede the success of a firm’s rescue attempt (Smith et al., 2008, p. 75). During times of change in distressed firms, stress, paranoia, and lack of trust between employees and management are at an all-time high. Thus, communication with employees is imperative to combat the decrease in employee morale, because employees need to feel that their fears and concerns are being heard (Bar-Or, 2009, p. 15).

Key employee and management turnover

The threat of job losses through retrenchments may reduce employee morale, and voluntary employee turnover may increase. Consequently, the retention of key employees may become a major challenge for the firm. The employees most likely to leave tend to be the most skilled, with valuable firm-specific knowledge and expertise (Liou & Smith, 2007, p. 87; Winer & Crook, 2016, p. 3). There may be a high turnover of key employees, both blue and white-collar, if other suitable jobs exist in the market. Furthermore, competitors may take advantage of the distressed firm’s position and headhunt key employees (Tajti, 2017, p. 11).

According to Altman and Hotchkiss (2006, p. 219) and Gilson (1990, p. 375), both senior management and board of director positions are likely to experience high turnover when a firm is in financial distress and consequently files for reorganisation proceedings. Management turnover may increase for several reasons. When a firm is in distress or files for reorganisation, stakeholders tend to view management as tainted and incompetent; thus management will receive most of the blame for the poor performance (Sutton & Callahan, 1987, p. 412). It is argued that the image of a firm and its management are intertwined. Thus, if stakeholders do not perceive management as credible, their faith in the firm erodes (Sutton & Callahan, 1987, p. 406). The loss of discredited managers, who feel embarrassed, fatigued or unable or unwilling to make the changes that are necessary for recovery may be deemed to have a lesser impact on the associated indirect costs (Gilson, 1990, p. 373; Smith & Graves, 2005, p. 307; Sutton & Callahan, 1987, p. 406). But the loss of good employees and management will, in all likelihood, result in indirect costs of financial distress (Gilson, 1990, p. 372).

The inability to raise finance

According to Cook and Pond (2006, p. 27), a major indirect cost that distressed firms face is under-investment. Under-investment is defined as the inability to raise finance. Firms entering financial distress are very likely cash deficient; thus obtaining finance to meet day-to-day operating expenses and covering direct insolvency costs is one of the most important success factors (Calitz & Freebody, 2016, p. 269; Cook & Pond, 2006, p. 27). Firms may face bigger challenges in raising finance when it is subject to reorganisation proceedings, as lenders are concerned about the success of proceedings (Calitz & Freebody, 2016, p. 270). The amount of free assets (i.e., unencumbered assets) increases the ability of a firm to acquire additional funds needed for a successful recovery. However, one of the biggest reasons firms in reorganisation fail to secure finance is the lack of security and available unencumbered assets (Calitz & Freebody, 2016, p. 266; Pretorius & Du Preez, 2013, p. 176; Smith & Graves, 2005, p. 307). Another factor affecting the firm’s ability to raise finance is its relationship with its existing creditors and the willingness of the creditors to participate in the reorganisation process (Winer & Crook, 2016, p. 2). In a situation where a firm is able to raise finance, creditors may demand higher interest rates as compensation for the increased risk (Bhabra & Yao, 2011, p. 46).

Pretorius and Du Preez (2013, p. 181) indicate that, in South Africa, the extent of post-commencement finance (PCF) is small to non-existent, because the uncertainty around the ranking of creditors during business rescue contributes to the inability of firms to raise finance. This has created an additional obstacle to the BRP's already difficult task of raising PCF (Calitz & Freebody, 2016, p. 273; Jones & Wellcome, 2016, p. 25; Stoop & Hutchison, 2017, p. 17). The lack of understanding of the business rescue legislation further contributes to the inability to raise PCF (Pretorius & Du Preez, 2013, p. 181).

Inefficient asset sales

Financially distressed firms are cash deficient and may be constrained in their ability to raise external finance to meet their obligations. One strategy for dealing with this involves restructuring the assets of the firm to generate cash to meet the firm's obligations (Hotchkiss, John, Mooradian & Thorburn, 2008, p. 11). According to Brown, James and Mooradian (1994) and Hotchkiss (1995), firms in financial distress exhibit a high frequency of asset sales, whether the firm opted for a formal reorganisation procedure or an out-of-court restructuring. Financial slack is generated by selling off the unencumbered assets that are not critical for the firm's operations (Hambrick & D'Aveni, 1988, p. 4; Lehn & Poulsen, 1989). However, firms are often seen to sell assets at depressed prices, in their "fire sale" attempts to free up cash (Andrade & Kaplan, 1998, p. 1471; Hotchkiss et al., 2008, p. 13).

A "fire sale" is defined as a forced sale of an asset at a depressed price. Assets sold in fire sales can trade at prices far below market value, causing severe losses to sellers (Shleifer & Vishny, 2011, p. 30). An asset can be sold at a discounted price for several reasons. An asset may be sold quickly to pay for urgent expenses, or when the firm may not be able to raise finance over the asset due to financial distress (Shleifer & Vishny, 2011, p. 31). In addition, assets may be sold at depressed prices when they are too industry-specific (i.e., specialised). When an asset is industry-specific, competitors of the distressed firm may be facing financial constraints of their own and will be unable to pay market values for assets. In the case of an industry downturn, distressed firms may be forced to sell to well-financed users, who place a lower value on the asset (Hotchkiss et al., 2008, p. 13; Pulvino, 1998, p. 940). In contrast, the proceeds of generic assets can be used productively in many industries; in this case proceeds should not be depressed (Pulvino, 1998, p. 942).

It can be argued that the sources of indirect costs, described in this literature review, may have a negative influence on business rescue proceedings and may present firms and BRPs with considerable challenges. This highlights the fact that there is a need to explore the indirect costs in the context of business rescue. The next section describes the research methodology undertaken in this study.

Methodology

Key Scientific beliefs of the researchers

The researchers were aware of how their own beliefs, values, and philosophical assumptions could influence how the research was conducted. These assumptions are stated in order to understand the intellectual climate in which the research took place.

Ontological positions comprise the researchers' views on the nature and essence of research. The researchers are objective realists who believe that knowledge comes from facts associated with real-life cases and their context. Their interest was, mainly, to understand and describe the indirect costs associated with business rescue proceedings in South Africa. Epistemology concerns what constitutes acceptable knowledge in a field of study and describes how researchers are able to discover underlying principles about social phenomena (Saunders, Lewis & Thornhill, 2009, p. 119). Researchers A and C have personal experience in the business rescue context, while researcher B, as a postgraduate student, has experience in research in the business rescue field.

Research approach

The research approach for this study was exploratory in nature and therefore a generic qualitative research design was employed to explore the indirect costs of business rescue proceedings in South Africa (Leedy & Ormrod, 2013, p. 96). The qualitative research allowed the researchers to explore the opinions, perceptions, or beliefs of multiple BRPs with regard to a specific topic under investigation: the indirect costs of business rescue (Plano Clarke & Creswell, 2015). The units of analysis for this study were licenced BRPs consisting of 13 BRPs from Gauteng in South Africa. The researchers selected BRPs from the Gauteng region due to capacity and time constraints. Guest, Bunce and Johnson (2006, p. 61) and Rowley (2012, p. 263) state that six to twelve interviews of approximately 30 minutes in length are sufficient for qualitative research. As a result, the final sample size and interview duration was deemed appropriate to reach data saturation. Purposive sampling, a non-probability sampling method, was used to select individual participants for this study. Participants were selected based on the following criteria: 1) participants had to hold a junior, experienced, or senior BRP licence; and 2) participants had to be involved in, or have administered, a minimum of one business rescue case. In addition to purposive sampling, snowball sampling was used to select participants.

Data for this study were collected through thirteen one-on-one semi-structured interviews with BRPs. Given the lack of current knowledge about the indirect costs of business rescue, semi-structured interviews were appropriate, as they allowed for new issues to emerge for exploration (Saunders et al., 2009, p. 117). A discussion guide was developed from an extensive literature review. The thirteen interviews lasted from 21 minutes to 68 minutes, with an average duration of 41 minutes.

A thematic analysis was conducted to analyse the interview data collected. Following the guidelines of Braun and Clarke (2012), the researchers first familiarised themselves with the data by analysing each transcript while listening to the audio recording. The researchers made notes on the data during this phase. Inductive codes were generated from the data and used to code applicable text segments. The first round of coding yielded 307 descriptive codes. The codes were then rethought, in terms of similarity and difference, and all redundant codes were combined through an iterative analysis. This process resulted in 77 codes. The revised codes were grouped into six descriptive and overarching themes. The identified themes were then analysed against the original transcripts to ensure that they covered all major patterns in the data. To ensure credibility, site triangulation was employed. Site triangulation made use of participants from several organisations so as to reduce the effects on the study of particular local factors that are specific to one organisation (Shenton, 2004, p. 66). To ensure transferability, the researchers provided a comprehensive description of the participants and the study's context (Shenton, 2004, p. 70). A comprehensive description of the processes the researchers employed in the study are reported in detail, to ensure dependability (Shenton, 2004, p. 70). Finally, the researchers stored all notes, transcripts and audio recordings in order to ensure confirmability (Milne & Oberle, 2005, p. 416).

Findings

In order to answer this study's main research question, this study investigated six main sources of indirect costs (themes) related to the study's six sub-research questions (see Figure 1). These themes and their related sub-themes are discussed in this section, accompanied by descriptive quotations from participants and linkages to relevant literature.

Research questions					
What indirect costs do companies experience while undergoing business rescue proceedings in South Africa?					
Do companies experience a loss of customer goodwill during business rescue?	Do companies experience a loss of supplier goodwill during business rescue?	Do companies experience a decrease in employee morale and productivity during business rescue?	Do companies experience a high turnover of key employees and management during business rescue?	Do companies face challenges in raising finance during business rescue?	Do companies sell assets at depressed prices during business rescue?
Themes: Sources of indirect costs					
Loss of customer goodwill	Loss of supplier goodwill	Decrease in employee morale and productivity	Key employee and management turnover	Inability to raise finance	Inefficient asset sales
Sub-themes					
- Challenges faced with customers - Factors influencing customer goodwill	- Challenges faced with suppliers - Factors influencing supplier goodwill	- Challenges faced with employees - Factors influencing employee morale	- Challenges faced with employee turnover - Factors influencing employee turnover	- Challenges in raising PCF - Factors influencing the ability to raise PCF	- Asset sales as a method to raise finance - Factors influencing proceeds

Figure 1: Summary of research questions and related themes (own compilation)

Loss of customer goodwill

Challenges faced with customers

Participants offered mixed opinions as to whether a firm experiences a loss of customer goodwill during business rescue. Insofar as customers are kept informed and supply is not interrupted, customers may exhibit a large extent of loyalty during business rescue. In contrast, several participants indicated that firms may experience difficulties with customers for various reasons. Customers may worry about a firm's ability to supply, as they are concerned about the longevity of the firm. This is because business rescue is viewed as akin to liquidation. Customers may worry about the product quality and as a result, may mitigate their risk by finding alternative sources of supply.

Firms may experience other difficulties from customers; for example, customers often stop paying their debts as they do not believe the firm will be around for long. This is consistent with Tajti (2017, p. 10). Based on the above discussion, it may be concluded that a loss of customer goodwill may result in lost opportunities in the form of lost sales. This may result in cash flow problems, which may further exasperate financial distress.

Factors influencing customer goodwill

Consistent with the findings of Farooq and Jibran (2018, p. 120), the findings of this study highlight the fact that firms may experience a loss of customer goodwill due to competitor activity. Competitors may take advantage of the firm’s weaknesses by using aggressive marketing strategies to capture the distressed firm's market share. The following quotation illustrates this:

> “Because the business rescue process is so transparent, your competitors can get a hold of the business rescue plan and know exactly what the state of your business is and kind of take advantage of your weaknesses by going for your customers. So, it could affect your sales, you know you could lose some key customers.” (BRP07)

Participants highlighted three types of product or service where a firm may typically experience a loss of customer goodwill during business rescue. Firstly, firms that produce products that require after-sales services and come with guarantees. Secondly, firms that supply components that are inputs to their customer’s products. These inputs may be critical to the customer’s products, therefore losing supply of these components will affect the customer’s sales. Lastly, firms whose products or services require deposits or pre-payments experience the biggest loss of customer goodwill. Participants stated that during proceedings, the firm would not be awarded new contracts or tenders. In all three instances, customers are concerned about the longevity of the firm and will not take the risk and may therefore seek alternative suppliers.

Alternatively, participants indicated that firms that produce consumer goods and commodities typically do not experience a loss of customer goodwill. In this instance, if the distressed firm is unable to supply goods, they are easily available and can be replaced quickly. In addition, firms in the retail industry typically do not experience a loss of customer goodwill as long as they still have products on their shelves. In fact, one participant highlighted an instance where there was an increase in sales. Based on the above discussion, it appears that a customer’s reaction to business rescue may be dependent on whether the firm is a business-to-business or business-to-customer supplier. The following quotation illustrates this argument:

> “Retailer B went into rescue and our sales performance went up in the stores and I don’t know quite how that worked but if you track it you can see that more customers were going into the store. Now I don’t know whether that’s because its name was in the press more…but there was no sort of customer-focused indirect cost.” (BRP10)

Customer goodwill depends on how the BRP manages relationships with customers. Customers have many questions during proceedings; therefore it is important for the BRP to respond to a customer’s questions and concerns. Participants emphasised how important it is to go to see major customers right at the beginning of proceedings to ensure that supply will not be interrupted. Participants stressed that it is important to be open and honest from the beginning of proceedings. Ongoing communication with customers and keeping customers updated throughout the process is imperative to ensure that customers do not lose confidence in the process. Moreover, participants stated that goodwill also comes down to the BRPs’ skill and how proactive they are in implementing systems and procedures that will bring customers comfort.

Lastly, customer knowledge of proceedings may influence whether firms experience a loss in goodwill. Firms are not legally required to notify customers that they are in business rescue; therefore in some instances customers do not even know their suppliers are in business rescue and as a result these firms may not experience a loss in goodwill.

Loss of supplier goodwill

Challenges faced with suppliers

There was a consensus amongst participants that firms face massive challenges with suppliers after filing for business rescue. Consistent with the findings of Pretorius (2015, p. 65), during proceedings suppliers often refuse to extend trade credit and tend to put firms on aggressive payment schedules, such as requesting COD or cash-in-advance (CIA). Other difficulties mentioned were that suppliers may attempt to increase the cost of goods and services supplied to recover the debt owed before business rescue. In addition, suppliers may refuse to continue doing business with the firm until the firm settles their arrears. One participant indicated that in some instances suppliers insist on CIA, then use that payment to settle old debt and do not deliver the goods. The following quotation illustrates this:

> "…then what also happens is they say 'we will supply you on cash' then you pay the cash and then they don't deliver. They just say they will put it off your old account. That does happen, very unprofessional but it does happen." (BRP13)

It appears that firms face major challenges with banks when filing for business rescue. In fact, one participant believed banks are one of the biggest obstacles to a business rescue attempt. As soon as a firm files for proceedings, banks are likely to withdraw facilities by cancelling overdraft facilities or freezing the firm's bank accounts. One of the reasons banks withdraw facilities is because the overdraft facility is secured by a cession of debtors. In this instance, banks are of the opinion that the debtors of the firm remain the property of the bank. Banks may also increase interest rates charged on bank accounts. The difficulties BRPs face with banks is illustrated by the following quotation:

> "…the bank froze the account immediately. We convinced them to open a new account, but then it took us two weeks to get statements on the old accounts so that we can say 'these deposits are post-rescue deposits and you have to give them to us'. Sometimes the bank refuses to give them to us then you have to go to court for an urgent application to compel them to act." (BRP10)

Participants indicated that BRPs need to spend a substantial amount of time dealing with suppliers in order to minimise the issues mentioned above. Participants indicated that many suppliers still do not understand business rescue. BRPs therefore need to spend time negotiating with suppliers and answering their questions and concerns. As a result, these difficulties distract BRPs from the task at hand, which is rescuing the firm.

Participants reinforced existing literature that a lack of support from suppliers may be detrimental to a firm's business rescue attempt. The issues mentioned above may place additional pressure on a firm's immediate cash flow. Consequently, a firm may not be able to purchase stock and therefore productivity may decline. The following quotation highlights this:

> "You can't get stock, you can't trade and then [the firm is] doomed for failure. So, it's really as simple as that. If your creditors don't support you in business rescue, I question if your business rescue can actually be successful." (BRP04)

Factors influencing supplier goodwill

The findings reveal that the firm's ability to pay cash has a major influence on supplier goodwill. If the firm is able to pay COD or CIA, it may experience minimal difficulties with suppliers. Some suppliers exhibit a large extent of loyalty; however, they cannot take further risks and therefore these suppliers will continue to support the firm but on a COD or CIA basis. Participants stated that once they had gained the trust of suppliers by purchasing on a COD or CIA basis, in some instances they were even able to renegotiate payment terms. Sometimes suppliers may even be willing to take a compromise on previous debt if the firm has started paying the supplier cash.

The extent to which suppliers are compromised in the business rescue plan may influence how they react and, in turn, how much difficulty a firm will experience with suppliers. This is evident by the following quotation:

> "If the plan is to pay them back all their money, then they are more lenient towards helping you out and to keep on supplying you, even at the existing terms…But if the plan has any sort of compromise, you can forget about them supplying you. They will go over to a cash basis. So, if you don't pay cash, they are not going to help you." (BRP13)

Management behaviour in the run-up to business rescue may often affect supplier goodwill more than the act of filing for proceedings (Cook & Pond, 2006, p. 28; Sutton & Callahan, 1987, p. 412). This is consistent with previous studies. Often, by the time a firm files for business rescue, the trust relationship between the firm and supplier has been broken down for several reasons. The firm may have lied about payment terms and may not have kept its promises. Or management may have hidden the financial distress and filed for business rescue. In this instance, suppliers react negatively because they were not taken into confidence and told that the firm was filing for business rescue.

Because of the above, participants indicated that supplier goodwill depends on the BRP's ability to restore and maintain relationships with suppliers. It is incumbent upon the BRP to have the necessary skills to placate suppliers and to convince suppliers to continue doing business with the firm. It is important to communicate with suppliers as early as possible and tell them what the circumstances are behind the financial distress and what the plan is moving forward. The

BRP's reputation in the market can further influence supplier goodwill and has an impact on the degree of the difficulty experienced with suppliers.

Decrease in employee morale and productivity

Challenges faced with employees

The findings indicated that the act of filing for business rescue, in itself, results in some adverse emotions among employees. As a result of business rescue's low success rate, employees judge rescue to be the death of the firm. As a result, when a firm files for business rescue, an employee's immediate reaction is: *Will I have a job? Will I get paid? Will the company succeed?* Therefore, filing for business rescue has a massive impact on an employee's sense of job security and stability. This confirms the research conducted by Vollmann and Brazas (1993, p. 21).

A decrease in employee morale may have several negative effects: employee absenteeism, decreased safety standards or increased theft. As a result, BRPs need to monitor employees and spend time engaging with employees. Participants indicate that this is a very time-consuming task. In summary, the decrease in employee morale and the consequent reduction in productivity may result in lost opportunities in the form of lost sales. A decrease in employee morale and productivity and its consequences are illustrated by the following quotes:

> "…employees started stealing wherever they could, because they say the company is not going to survive and they are going to be out of a job. The moment you go into business rescue you need to increase your security. Your employees will steal because they see this as a sinking ship." (BRP04)
>
> "… as a practitioner and management, you have to spend a lot of time engaging with [employees] and allowing them to ventilate and express their feelings. So, the most significant thing is that it takes a lot of time and energy from the practitioner to engage." (BRP01)

Factors influencing employee morale

The findings reveal that the level of education and the understanding of business rescue by the employees may influence whether an employee experiences a decrease in morale. Generally, blue-collar workers are unlikely to understand business rescue and therefore participants expressed that the morale of blue-collar workers may be largely influenced by a firm's ability to continue paying wages. This finding confirms that of Bewley (1998, p. 459), who states that employee morale is adversely affected by pay cuts. In contrast, white-collar workers may immediately become concerned about their long-term future at the firm and start searching for alternative employment. Consequently, firms may experience a high turnover of key employees.

The degree to which employees experience a decrease in morale may be affected by the BRP's communication skills. In line with Bar-Or (2009, p. 15), the findings indicated that during periods of uncertainty, employees need to feel that their fears and concerns are being heard. Participants stressed how important it is to communicate with employees and explain the cause of the distress and what the future plan is going forward. Therefore, the first employee meeting is critical for answering all questions and concerns. However, participants emphasised that the communication needs to be honest and transparent. The influence that a BRP's communication skills have on employee morale is illustrated below:

> "So, it [employee morale] depends on how well you communicate with large numbers of staff. So, you have to have active communication about what the process is, what's happening now, what's happening next, where are we with salaries and wages, when are they going to get paid. It's about your communication skills." (BRP08)

Lastly, it appears that a BRP's relationship with unions has an impact on the extent of difficulties faced with employees. Some participants are of the opinion that if employees are unionised, BRPs will experience more difficulties, as unions generally do not understand business rescue. In contrast, other participants emphasised that it is important to build a relationship with unions because communicating and dealing with employees is much easier through unions, as employees tend to trust unions.

Key employee and management turnover

Challenges faced with employee turnover

Consistent with previous studies (Altman & Hotchkiss, 2006; Gilson, 1990; Tajti, 2017), this study found that there is an increase in both voluntary and involuntary turnover during business rescue. In line with Liou and Smith (2007, p. 87), this study found that voluntary employee turnover may increase, especially amongst key employees. The loss of institutional knowledge may limit the ability of the BRP to make quick decisions. The following quotation highlights the importance of retaining good employees:

> "…it is that institutional knowledge and under circumstances where you are distressed you have to make quick calls and quick calls can only be made if you have good information; good information only comes from quality people." (BRP11)

When key employees leave, those positions need to be filled and may come with substantial costs. The firm may not be able to find suitable replacements, due firstly to the skill shortage in South Africa and secondly because the firm cannot offer prospective employees' job security. As a result, indirect costs may increase as the firm may have to fill the position with people of lesser competence. If a replacement is not available, the firm may need to replace employees with contractors and thereby increase the direct costs of business rescue, as these consultants may charge substantial hourly rates.

Contrary to the above, some participants stated that the increase in voluntary turnover is not always an issue; in fact, it can offer the firm some advantages. In some instances, there are employees that the firm would prefer to remove; if these employees voluntarily resign, it is a benefit. Participants indicated that employees often take voluntary retrenchments; therefore, the firm does not have to worry about retrenching employees. Lastly, some participants indicated that losing key employees was not a threat; they would make plans to fill the void.

This study found that there may be an increase in involuntary turnover of employees, specifically management, during business rescue. Participants stressed that it is often necessary to remove management in order to have a successful rescue. This is illustrated by the following quotation:

> "Here's the truth, I have never gone into a rescue with the intention of changing management, I have never come out of a rescue not having changed management. It's just, you need fresh people, it's required." (BRP06)

Consistent with previous studies conducted by Andrade and Kaplan (1998) and Sutton and Callahan (1987), this study found that the removal of poor management may offer a distressed firm some benefits. Employees do not want to follow management if they believe management is the problem. If management is changed, it is being held accountable for its actions and employees can view change and see that the firm is going in the right direction. In addition, participants indicated that the removal of bad management may also improve relationships with suppliers, as they can see change happening.

To sum up, firms in business rescue may experience an increase in employee turnover. This means that the firm may not be able to take advantage of certain opportunities because of the lack of human resources. Therefore, firms may experience indirect costs in the form of lost opportunities.

Factors influencing employee turnover

This study found that there are several factors that may influence employee turnover. Consistent with the findings of Tajti (2017, p. 11), competitors often seek to take advantage of firms during business rescue; therefore key employees are much more likely to be headhunted by a competitor. Key employees often have more options outside the firm than the less-than-stellar employees do, and therefore they are the first to leave.

Several participants indicated that it is important to take measures to ensure the firm does not lose good employees. One way to address the risk of losing key employees is to conduct a pre-assessment to identify employees who are critical to the business rescue, and incentivise them to stay and bring them on board as part of the business rescue effort. One participant emphasised that it is important not to drag out business rescue; the longer the proceedings take, the more employees lose confidence and the higher the turnover. The importance of taking measures to retain key employees is highlighted by the following quotation:

> "What we sometimes do in our matters, as part of our pre-assessment or early assessment, is we identify people who are critical for a successful rescue and you try and incentivise them to stay." (BRP11)

The findings revealed three occasions where there may be an increase in management turnover. Firstly, consistent with the findings of Raden (2015, p. 20), if the management team is the reason for the financial distress, or is *seen* as the reason for the distress, that same management team cannot be the one to take the firm out of trouble. Therefore, it is important to have a change in management. This is emphasised by the following:

> "You've got to ask yourself, if this board or management team managed to drive this bus up a dark alley they couldn't get out of, are they the right people to reverse it out? I'm not sure they are." (BRP06)

Secondly, participants mentioned cases where management was removed due to theft or fraud. Lastly, a critical factor for a successful rescue is unconditional support from management. Management may be an obstacle to the business rescue because it is resistant to change or because it is showing self-interested behaviour, which results in conflict. In these instances, it is important to remove management in order to continue with proceedings.

Inability to raise finance

Challenges in raising post-commencement finance

According to participants, without PCF a business rescue attempt cannot be successful, therefore, the ability to raise PCF is crucial. This is supported by Pretorius and Du Preez (2013, p. 189), who found that a lack of PCF is one of the main reasons for business rescues failing. One participant stressed the importance of PCF by indicating that he would not accept appointments without knowing whether he would be able to secure PCF.

Although PCF is one of the most important factors for a successful rescue, raising PCF during business rescue is one of the biggest challenges BRPs face. If a BRP is able to secure PCF, it comes at a higher cost in terms of the interest rate and fees charged, such as the raising fee charged. This is supported by Bhabra and Yao (2011, p. 46), who state that financiers may charge higher interest rates as compensation for the increased risk.

Firms in business rescue often lack the finance to run the day-to-day operations of the firm as well as the finance to repay creditors. As a result, firms may have to forgo profitable opportunities as they may lack the finance to expand into new markets or to invest in research and development. As a result, firms in business rescue may experience indirect costs in the form of lost opportunities.

Factors influencing the ability to raise post-commencement finance

Consistent with the findings of Pretorius and Du Preez (2013, p. 181), this study found that one of the main reasons that BRPs struggle to raise PCF is that the distressed lending market is underdeveloped and virtually non-existent in South Africa. As a result, firms must turn to other parties – such as major lenders, shareholders or private equity lenders – for funding. However, firms still face major challenges in raising PCF from these parties. The ability of a BRP to raise PCF depends on the security available. But by the time a firm has filed for proceedings, most firms do not have free assets left to use for securing PCF. Participants emphasised that having security available is only the first step in the process of obtaining PCF. In addition to considering the firm's security, lenders typically consider the BRP's reputation and the management of the firm.

In line with Jones and Wellcome (2016, p. 25) and Stoop and Hutchison (2017, p. 17), the findings indicate that the uncertainty around the ranking of creditors during business rescue proceedings contributes to the inability of firms to raise finance. The following quotation illustrates this:

> "There's just not enough certainty around the ranking and we all know what it's intended to mean but it doesn't say that, so your sources of PCF funding are limited." (BRP11)

Often, firms cannot raise finance from various parties; they have lost credibility with these parties because they have not honoured previous commitments, or management is blamed for the distress. This finding is supported by Winer and Crook (2016, p. 2), who state that the ability to raise PCF largely depends on the firm's relationship with its existing creditors. It appears that a BRP's reputation plays an important role in a firm's ability to raise PCF. There are some BRPs that banks will not work with due to past experiences. The following quotation supports this:

> "Oh yes, practitioner reputation is the most important thing. They will not even look at the assets if the wrong practitioner is in place. They will not provide finance to the wrong practitioner or to someone they had a negative experience with before." (BRP05)

Inefficient asset sales

Asset sales as a method to raise finance

According to Hotchkiss et al. (2008, p. 11), one strategy to deal with financial distress involves the sale of assets, such as equipment or subsidiaries, to generate cash to meet the firm's obligations. Participants agreed that this is a strategy often used during business rescue to raise cash to repay creditors or to fund the firm’s operations. However, asset sales need to be part of the business rescue plan and approved by creditors, in order to avoid prejudicing creditors.

Participants indicated that BRPs typically consider selling underutilised assets, superfluous assets or obsolete assets. Participants warned against selling income-generating assets or assets that would affect the core operations of the firm. In some instances, BRPs may sell non-core subsidiaries that have the potential to be a lucrative business in the future. Although this may result in lost opportunities in the form of lost sales, it is sometimes imperative to save the core business, especially in cases where the firm cannot raise PCF. The importance of asset sales is emphasised by the following quotation:

> “…you must remember what I’m trying to do is avoid liquidation. So, if it’s that I end up with half the business that I had before, but I put everybody in a better position than they would have been under liquidation, then I’m surely in a better position. So, if I keep two divisions and they go into liquidation or if I had one and I’m solvent and my creditors get paid, surely there’s no debate.” (BRP06)

In contrast, participants indicated that often assets are not sold during proceedings, because by the time the firm files for business rescue, there are no free assets left. This finding is consistent with previous studies indicating that firms in reorganisation do not have sufficient free assets (Calitz & Freebody, 2016, p. 266; Pretorius & Du Preez, 2013, p. 176; Smith & Graves, 2005, p. 307). In these instances, management may have sold off assets and raised finance over some of them in an attempt to resolve the financial distress. Participants stated that this signals that a firm may have filed for proceedings too late and may eventually land up in liquidation. The following quotation illustrates this:

> “Usually when you get there all unencumbered assets are gone, they are already sold. So that puts the emphasis on filing for business rescue in good time. If you’re going to start selling off assets, it’s too late to file for business rescue basically.” (BRP09)

Factors influencing proceeds

According to participants, assets sold during business rescue are typically sold for a value between forced sale value and market value. Therefore, proceeds are normally fair under the circumstances. Asset sale proceeds depend on several factors. Firstly, the proceeds will depend on how quickly the BRP needs to sell the asset. If the asset needs to be sold urgently, then it will most likely be sold at a discount. Secondly, proceeds will depend on the type of asset sold. Inevitably, the more specialised the asset, the lower the proceeds. This finding confirms that of Pulvino (1998), who found that firms who sell specialised assets typically receive discounted rates, compared with a firm selling a generic asset. Lastly, if buyers know that the seller is in business rescue, they often try to take advantage of the firm's position and as a result, make a low offer. Although proceeds of asset sales are often discounted, participants indicated that sometimes these sales are important if they can save the core business.

Conclusion

The purpose of this qualitative study was to explore the indirect costs financially distressed firms face as a consequence of participating in business rescue proceedings in South Africa. Figure 2 displays a visual depiction summarising the findings of this research.

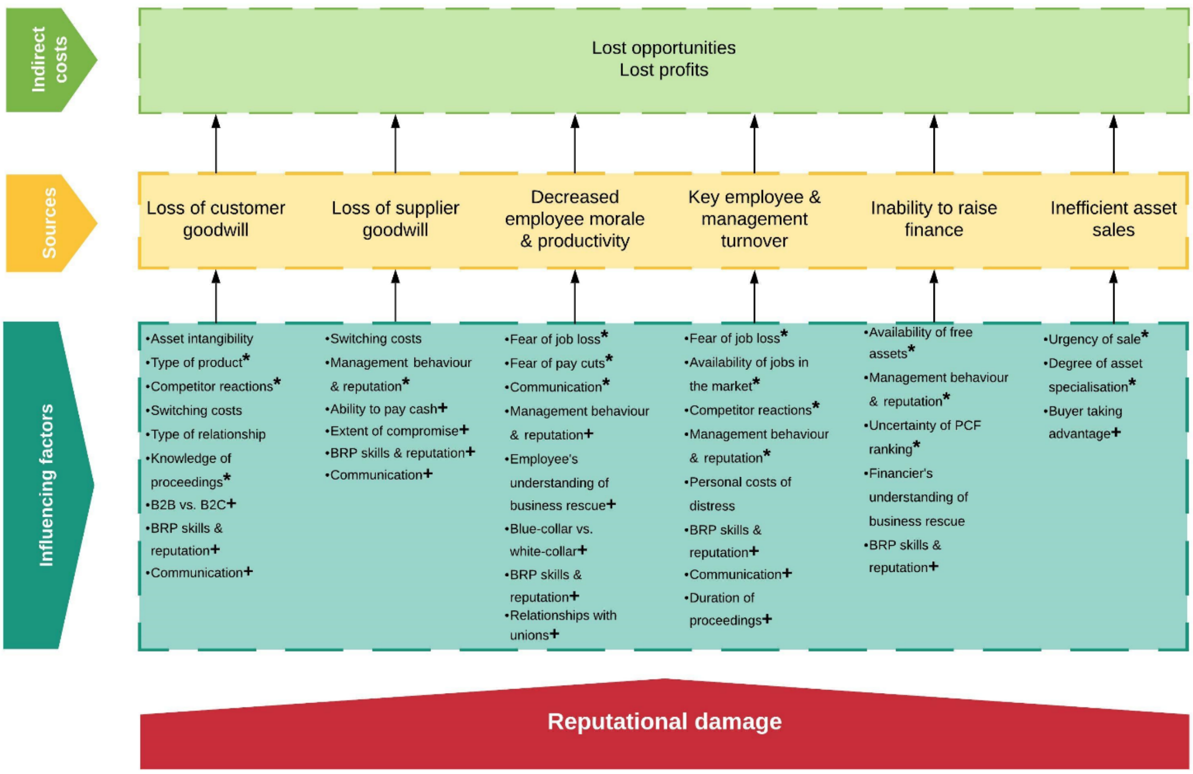

Figure 2: A visual depiction of indirect financial distress costs in South Africa (own compilation)

Notes:

* = Influencing factor identified in literature is supported by findings.

+ = additional influencing factors identified by the study.

The first level of Figure 2 displays the two indirect costs of financial distress most widely measured in literature. The second level displays the six sources of indirect costs investigated in this study. The findings of the study reveal that firms in business rescue experience the following: a loss of customer and supplier goodwill; a decrease in employee morale and productivity; increased turnover of key employees and management; the inability to raise finance; and inefficient asset sales. The third level displays the factors that influence the sources of indirect costs that were identified from the literature and that were supported by the findings of the study. In addition, the figure displays the additional influencing factors found in the study that were not highlighted in the literature.

Although firms in business rescue may be affected by indirect costs, it appears that indirect business rescue costs may actually offer firms several benefits. Firstly, a firm may not have to retrench employees due to the increase in voluntary employee turnover. Secondly, the removal of poor management may increase employee morale and improve relationships with various stakeholder groups. Lastly, although the sale of assets may result in lost opportunities, it may save the core business. In addition, the sale of assets may result in the sale of poorly performing assets.

Limitations and recommendations for future research

This study underwent four main limitations. Firstly, this study only considered the perspective of one stakeholder group, namely that of the BRP. As a result, the findings only reflect a single point of view, which may be incomplete and biased. Secondly, the researchers only interviewed BRPs located in the Gauteng region. Although the sample of BRPs interviewed in the study conduct business rescue procedures throughout South Africa, the researchers are aware that the results may not be representative of the BRP population in South Africa. Thirdly, the responses from participants may be subjected to social desirability bias, due to the fact that business rescue has been heavily criticised (Saunders et al., 2009, p. 327). Future research should involve other stakeholder groups located throughout South Africa, such as large creditors, directors of firms, and employees, in order to attain more diverse perspectives. Lastly, although Guest et al. (2006, p. 61) state that six to twelve interviews are sufficient for qualitative research, the researcher acknowledges that the number of participants interviewed limits the generalisability of the findings. Although the findings cannot be generalised, this study provides a starting point for future research into the indirect costs of business rescue proceedings. Future research should consider conducting a quantitative investigation to measure the indirect costs of business rescue.

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