



Turnaround Prediction Model with Content Dimension on Financial Distressed Firms

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ABSTRACT

Objectives - This article aims to examine the influence of content dimensions of Organization Change Theory, such as CEO Expertise, Free Assets, Debt to Equity Ratio and Growth of Sales, on a company's turnaround ability when it is experiencing financial distress. The companies examined are listed on the Indonesian Stock Exchange (IDX).

Methodology/Technique - The population used in this study is companies from sectors excluding the finance sector that were listed on the Indonesian Stock Exchange between 2013 and 2018. The sample size was determined using purposive sampling method. From the 109 companies that experienced financial distress, 57 have successfully turned their business around. The research data was collected from the ICMD (Indonesian Capital Market Directory), which was then analysed using multi regression technique analysis, using SPSS software to examine the determinants of company turnaround ability.

Finding - The results indicate that CEO Expertise, Debt to Equity Ratio and Growth of Sales have a negative relationship on a company's turnaround ability. Meanwhile, Free Assets has a positive and significant relationship on a company's turnaround ability.

Novelty - Previous studies have been conducted in many western countries, giving rise to researchers' doubts about the generalizability of research based on previous research findings when applied in developing countries such as Indonesia, particularly due to differences in regulations, conditions of distress, culture, financial systems and strategies used in overcoming distress.

Type of Paper: Empirical.

JEL Classification: B26, G15, P34.

Keywords: Financial Distress; Turnaround Model; CEO Expertise; Free Assets; Debt to Equity Ratio; Growth of Sales

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1. Introduction

Uncertainty in economic conditions can result in companies experiencing financial distress and even bankruptcy (Friedman et. al., 1985). Financial distress refers to the stage before the liquidation or bankruptcy process (Platt & Platt, 2002), which is usually characterized by a decline in stock prices (Fama, 1978; Wright & Ferris, 1997; Walker, 2000).

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Research on financial distress and turnaround has a close relationship because the success of turnaround is determined by the company's response to financial distress conditions (Smith & Graves, 2005). Turnaround is defined as the reversal of the direction of the company in terms of financial performance (Schendel, Patton & Riggs, 1976). Successful turnaround is a complex process; the implementation of an effective strategy to reverse the factors that cause a decline in financial performance is important for successful turnaround (Schendel & Patton, 1976 in Francis & Desai, 2005). According to Goldston (1992) in Bruton et. al., (2003), strategic solutions include repositioning companies that are relevant to competitive conditions and arranging assets appropriately to compete better within a given market. Operating solutions include retrenchment such as reducing assets and marketing costs and increasing sales (Chen & Miller, 1994; Hofer, 1980; Bruton et. al., 2003). However, for a company to successfully turn their performance around, both operational and strategy controls typically provide fewer comprehensive results which can sometimes lead to biased and uncertain conclusions.

Rosenkopf (1996) and Trahms et. al. (2013) state that the integration of turnaround studies with organization change theory can overcome the gaps and shortcomings of the dichotomous classification of turnaround. Organization Change Theory, which is an integration of the organizational change framework into turnaround research, is used to measure the activities undertaken by companies to avoid failure. The framework significantly exceeds the operational dimensions of the process and strategy (De Witt, 1993; Domadenik et. al., 2008; Lim et. al., 2013). The content dimensions included in the framework of Organization Change Theory include various strategies related to turnaround, which can be grouped into four categories: operational restructuring, managerial restructuring, debt restructuring and financial restructuring. Each category offers many sub-sets of changes for turnaround (Lai & Sudarsanam, 1997)

Based on the framework of the Organization Change Theory, the researcher wants to propose the determinants of company's turnaround variables based on content dimensions such as sales growth, free asset, debt to equity ratio and CEO expertise, which will ultimately lead to a successful turnaround. Previous studies have been conducted in many western countries, giving rise to researchers' doubts about the generalizability of research based on previous research findings when applied in developing countries such as Indonesia, particularly due to differences in regulations, conditions of distress, culture, financial systems and strategies used in overcoming distress.

2. Literature Review

2.1. Content Dimensions

Based on the Organization Change Theory, the content dimension analyzes the different strategies and activities carried out during turnaround, which includes operational, managerial, debt and financial restructuring (Eichner). Operational restructuring is related to product development and sales (sales growth). Managerial restructuring relates to changing the CEO as an integral part of any turnaround effort (Bibeault, 1982; Boeker, 1997; Hofer, 1980), or retaining the CEO because they have experience or expertise (Lepak, 2010; and Zeni et. al., 2007). Debt restructuring relates to equity that allows firms to share risk with creditors, to minimize distress (Gertler & Hubbard, 1993). However, this condition creates a bias towards equity (Asquith et. al., 1994; Berk et. al., 2010), as an indicator of debt restructuring is debt to equity ratio. Liquidity restructuring in the context of turnaround refers to the process of restructuring debt or liquidity (John, 1993). Liquidity improvements include optimizing working capital, cutting dividends, or issuing shares (Eichner, 2010; Opler, 1993). As an indicator of liquidity, restructuring is a free asset. The results of a company's turnaround ability is measured using price to book value (PBV), which is a comparison of the market price of a stock with its book value (Clarke, 2003).

2.2 The relationship between sales growth and a company's turnaround ability

Innovation in processes and products are integral to a company's survival (Opler & Titman, 1994), but innovation in products can also be counterproductive and hinder operational performance (Cottrel & Nault, 2004). Product innovation is important as long as companies experience financial performance pressures, because innovation has an impact on sales growth and can increase company liquidity (Cefis & Narsili, 2005; Ketchen & Palmer, 1999). Sales growth has an impact on investment because with a high growth rate, the company will be able to fulfill its financial obligations and therefore can support the company's ability to turn around its performance. Based on the explanation above, the following hypothesis is proposed:

H1: Sales growth has a positive effect on a company's turnaround ability.

2.3 The relationship between CEO expertise and a company's turnaround ability

A change of top management (CEO) is often carried out by companies that are recovering from financial performance pressures in order to survive. New managers are expected to provide new insights for changing situations (Pearche & Robbin, 2003) O'Neil (1986) in Brutton et. al., (2003) states that CEO change can help contribute new ideas, but a successful company does not always need a CEO change. According to a study by Chandrawati (2008), CEO change has no effect on turnaround success, because the new CEO does not necessarily know the underlying conditions of the company, so they cannot implement the right strategy to achieve turnaround success. Based on the above statement, the following hypothesis is proposed:

H2: CEO expertise has a positive effect on a company's turnaround ability.

2.4 The relationship between free assets and a company's turnaround ability

Free assets are assets that are not guaranteed to creditors. Free company assets will help the company to overcome the effects of deteriorating financial performance because companies that have more free assets have a better chance of survival during periods of decline (Barker & Mone, 1998; Francis & Desai, 2005). However, according to Makgeta (2010), free assets have no effect on the success of turnaround. This is because the availability of free assets does not represent all of the company's assets and is the main guarantee for banks or other financial institutions in deciding to provide loans to companies. Based on the above statement, the following hypothesis is proposed:

H3: Free assets have a positive effect on a company's turnaround ability.

2.5 The relationship between debt to equity ratio and a company's turnaround ability

One of the main contributions of restructuring is debt. Gilson et. al., (1990) found that 50% of distressed firms were successful in using foreign sources during restructuring. Kalay et. al. (2007) further state that companies with higher debt ratios will experience a greater increase in performance. George and Hwang (2010) and Routledge and Gadenne (2000) conclude that companies with debt can experience higher turnaround success. On the other hand, decreasing or removing dividends in order to increase liquidity will lead to agency conflicts with shareholders, but an increase in company liquidity can pay off the company's financial obligations. In addition, a large debt value will actually be more burdensome for companies that are in distress, because overleverage is usually the main cause of financial difficulty (Molina, 2005). According to Zingales (1998), high leverage reduces the chances of survival by limiting investment. GirouDET et. al. (2012) found that there was a significant increase in performance after debt reduction was carried out. Based on the above statement, the following hypothesis is proposed:

H4: *Debt to Equity ratio (DER) has a negative effect on a company's turnaround ability.*

2.6 Company's Turnaround Ability

Outcome, which is the result of the company's turnaround ability from experiencing distress, is measured using price to book value (PBV), which is a comparison of the market price of a stock with its book value (Clarke, 2003). PBV is an indicator used in company performance. Shares that have a high PBV are considered more expensive than the price of other similar shares. Highly priced stocks usually reflect the good quality of the company's performance and its fairly rapid growth. Stocks like this will be in demand by investors and will generate high stock returns, thus accelerating the company's turnaround process. Furthermore, the success of turnaround with content dimension as a part of Organization Change Theory is measured using Price to Book Value (Wan & Yiu, 2009).

3. Research Methodology

This research uses an explanatory quantitative approach. According to Cooper and Schindler (2003:146), explanatory research has a flexible structure and is used to reveal future research assignments. The sample size was determined using purposive sampling method. From the 109 companies that experienced financial distress, 57 have successfully turned around their performance (2013-2018). This research uses secondary data with documentation technique. Data is collected from financial reports that have been published by the Indonesian Stock Exchange through the Indonesian Capital Market Directory (ICMD) and JSX Statistics, not including the financial sector. Based on the hypotheses formulated above, the analysis carried out in this study uses multiple regression. This method is used to determine the effect between the independent variable and the dependent variable. The calculations are conducted using SPSS Windows version 16.0.

4. Result and Discussion

Table 1. T-test Regression Model

Model	Unstandardized	Coefficient	Standardized	t	Sig
	B	Std Error	Beta		
1(Constant)	5.396	.225		24.000	.000
CEO	-.017	.005	-.153	-3.396	.001
Free Asset	2.708	.348	.342	7.785	.000
Sales Growth	-.293	.347	-.038	-.858	.392
DER	-.003	.018	-.008	-.171	.864

a. Dependent Variable: PBV
Processed data sources, 2019

The results show that the probability value of CEO (X1) on company turnaround ability is 0.001 with a t-count value of - 3.396. From the regression output, it can be seen that the level of significance of the CEO variable is smaller than the significance level of 0.05 (5%). Thus, the results of the t test between CEO (X1) and company's turnaround ability have a negative effect. The results of this study are not consistent with the results of research conducted by Pearce and Robbin (2003) or O'Neil (1986) in Brutton et. al., (2003).

The probability value of Free Assets (X2) on company turnaround ability is 0.000 with a t-count value of 7,785. The level of significance (0.000) of the Free Assets variable is smaller than 0.05 (5%). Thus, the results of the t test between Free Assets (X2) and company turnaround ability have a positive and significant effect. The results of this study are strengthened by several previous studies, such as research conducted by Barker and Mone (1998) and Francis and Desai (2005).

The probability value of Sales Growth (X3) on company turnaround ability is 0.392 with a t- count value of -.858. The level of significance of the Sales Growth variable is greater than 0.05 (5%). Thus, the results between Sales Growth (X3) and company turnaround ability have a negative effect. This is consistent with research by Cottrel and Nault (2004).

The probability value of DER (X4) on company turnaround ability is 0.864, with t-count value of -171, which is greater than 0.05 (5%). Thus, the results of the t test between DER on-company turnaround ability have a negative effect. The results of this study are consistent with the results of research by Zingale (1998) and Giroudet et. al. (2012).

5. Conclusion

The results show that the CEO expertise has a negative effect on company turnaround ability. This means that maintaining the incumbent CEO can explain turnaround, because senior managers have experience in identifying problems, but sometimes find it difficult to accept change (Barker & Patterson, 2001) or provide threats when a performance crisis occurs (Barker & Mone, 1998).

Sales growth does not have a significant relationship with company turnaround, meaning that sales growth resulting from product innovation has no effect on company turnaround ability. Product innovation will encourage companies to review and revise their development strategies (Hambrick et. al., 1983), with significant investment value. Hence, the results of innovation and new technology are not an important strategy for company turnaround.

Free Assets (X) and company turnaround ability are stated to have a significant positive effect, because free assets owned by the company provide confidence to creditors that there are assets available as collateral for debt. The greater the free assets available, the higher the success of the turnaround (Barker & Duhaime, 1997). In addition, the amount of free assets is important to differentiate between distressed companies that are successful in turnaround and liquidated companies.

Debt to equity ratio (DER) has no effect on company turnaround ability. In other words, companies must be careful in using debt as a turnaround strategy, bearing in mind the risk that debt defaults will result in failure to turnaround. This condition of the company is likely to reduce investor interest and decrease the value of the firm.

The results of this study indicate that CEO expertise, Debt to Equity Ratio and Growth of Sales do not have a relationship with company turnaround ability because, in the case of Indonesia, family companies are reluctant to change managers who are family members and investor are typically less interested in companies that have high levels of debt. In addition, free assets are important to provide confidence to creditors; the greater the free assets are, the more success a company will experience in turning around its' performance.

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