

Chapter 2

Literature Review

Bank connections are commonly found in most economies (Boot, 2000; Ongena and Smith, 2000). In practice, they adopt a monitoring role in ensuring that firms are able to repay their loans, and in gathering updated information to review firms' financial status and operations. The extent to which banks participate or play such a monitoring role in firms, depends on the development of a financial system and institutions in each country. In countries with active capital markets, market control mechanisms and financial service institutions, such as credit rating and information outsourcing companies, act to monitor firms, and this allows banks to lessen their monitoring effort because such activity is complemented by market control and the monitoring roles of other financial service institutions. In other countries, market control does not play an active role in disciplining a firm's management and financial service companies are not well established.

Connections between firms and banks result in both benefits and costs. Bank connections reduce information asymmetry problems, thus leading to easy access to bank loans and preferential credit terms. They are also beneficial in terms of governing and rescuing connected firms that face financial distress or have poor performance. Nevertheless, soft budget constraints and hold-up problems are adverse consequences of bank connections. Close ties with banks or a high dependence on bank lending also adversely affect firm performance and lead to over-lending and over-investment problems. Studies concerning bank connections have been investigated in the context of dispersed ownership in developed countries, and evidence of bank connections in the context of family-owned institutions in emerging markets is lacking and needs further investigation to provide additional insight into connections between firms and banks.

Restructuring activities are one of a firm's key financial strategies. During a crisis, such activities are crucial since a firm struggles to survive and then recovers, or just lets die. Existing literature documents restructuring actions as corporate responses to both performance deterioration and adverse macroeconomic conditions. Previous studies show significant factors that determine the probability of restructuring activities. However, no study has investigated the impact of bank connections on the restructuring likelihood,

although connected banks can play an important role such as advising and monitoring during the firm's difficult time. This will be the focus of our study. More specifically, our study examines whether bank connections help firms engage in restructuring activities. Findings from this research will provide additional evidence on the role of connected-banks on a firm's financial strategy in response to a crisis.

The chapter proceeds as follows. Section 2.1 reviews the literature on the significance of bank connections. Section 2.2 gives an overview of how firms restructure to improve performance, avoid bankruptcy, and cope with an economic crisis. Section 2.3 discusses the impact of bank connections on firm restructuring decisions, and introduces hypotheses regarding the impact of bank connections on the likelihood that a firm will restructure. Section 2.4 discusses other factors that determine the restructuring likelihood.

2.1 The significance of bank connections

Mayer (1990) notes that banks act as financial intermediaries to reduce information asymmetries. Banks appear to improve contract enforcement and reduce agency problems. They seem to control and participate in firms' business by monitoring credit compliance and providing management advice. Diamond (1984, 1996) discusses the role of financial intermediaries and benefits of bank monitoring in the arms' length financial system. Active monitoring may minimize the costs of firms' financial distress. Public debt holders and public equity holders tend to have no incentive to monitor firms as a result of higher monitoring costs. In addition, Diamond (1991) suggests that the benefits of bank monitoring increase firms' access to other sources of external funds. Through the monitoring process, firms may acquire reputation, which could be used to predict their future profits. Thus, firms can rely on reputation in obtaining access to public debts.

The existence of bank connections significantly affects firm value. James (1987) finds that stock prices of the borrowing firms significantly increase as a result of loan announcements, while the announcements of private placements and public debts are negatively associated with stock prices. Using the German firms, Gorton and Schmid (2000) find that firm performance is positively related to banks' equity control rights and concentration of control rights. In addition, Limpaphayom and Polwitoon (2004) find that the relationship between bank equity ownership and firm performance is non-linear in Thailand. The percentage of bank ownership (a proxy for bank relationship) is positively related to Tobin's Q ratio (a

measure of firm performance) at a lower level of bank equity ownership, but negatively related at a higher level of bank ownership. It is important to note that the definition of bank relationships used in this study may under-estimate the real bank relationships that could be traced through ultimate shareholdings in the institutional framework of concentrated ownership and family business groups in Thailand.

Firms that have developed relationships with banks possibly become more stable because they are able to secure a committed source of funds (Neuberger and Rathke, 2009). More importantly, they may also receive preferential credits to reduce their cost of capital (Greenbaum and Thakor, 1995; Boot, 2000). Berger and Udell (1995) also find that banks grant lower interest rate loans to firms with longer bank relationships. These firms have a lower possibility of pledging collateral to banks. Furthermore, Petersen and Rajan (1994) show that the likelihood of late payments on trade credits is negatively related to a length of the longest relationship with a bank.

Although bank relationships are crucial and contribute to various benefits, they result in several drawbacks. Boot (2000) discusses the adverse consequences of relationships between firms and banks, categorizing these into soft budget constraints and hold-up problems.² Close ties between firms and banks not only lead to ineffective contract enforcement, but also result in the looting dilemma. La Porta et al. (2003) show that the controlling shareholders use their control over lending policies and channel bank capital to their related parties and other private businesses in Mexico. Such imprudent related lending also leads to over-lending and over-investment problems, which eventually lead to financial crises (Rajan and Zingales, 1998; Pomerleano, 1998).

In some circumstances, bank relationships adversely affect firm performance. Kang and Stulz (2000) document that during the decline of the stock market when connected banks faced financial problems and decreased bank lending, firms that were more dependent on bank loans experienced poorer stock returns and lower investment. Furthermore, Bae et al. (2002) also find that the negative news announcements led to a decline in cumulative abnormal returns of banks and of their client firms. In Thailand, firms with bank connections obtained

² The term “soft budget constraint” has been used in the previous literature on the socialist system.

easier access to bank loans in the pre-crisis; however they poorly performed during the financial crisis (Sitthipongpanich, 2009; Espenlaub et al., 2010).

2.2 Firm restructurings in response to crisis

Restructuring actions are well documented as firm responses to performance deterioration (Jain, 1985; John et al., 1992; Ofek, 1993; Kang and Shivdasani, 1997; Lai and Sudarsanam, 1997; Denis and Kruse, 2000; Kang et al., 2001; Frederikslust et al., 2003). The primary objective of restructuring actions is to recover from doing poorly relative to past performances or to competing firms (Brickley and Van Drunen, 1990). In many cases, though, restructuring actions are also undertaken in order that firms may avoid (further) financial distress or bankruptcy (Khanna and Poulsen, 1995). Recent research also shows that firms restructure in response to adverse macroeconomic conditions (Lai and Sudarsanam, 1997; Gilson, 2001; Baek et al., 2002; Faccio and Sengupta, 2006; Kang et al., 2010).

Corporate restructuring can be broadly categorized into *six* major activities. First, firms engage in *downsizing actions*, which includes asset sales, divestitures, plant closures, operational discontinuations, capital expenditure cuts, unit spin-offs, office/branch shutdowns, capacity reductions, and refocusing.³ Second, firms conduct *expansionary actions* that increase the size or scope of businesses.⁴ These actions include, for example, acquisitions, joint ventures, new plant construction, new subsidiary setup, and capital expenditure increases. Third, firms undertake *employment changes*. These changes include employee layoffs, wage cuts, and the offering of early retirement incentives.⁵ Fourth, firms implement *internal control changes*. For example, a firm may replace top management, appoint new board members or dismiss existing board members, and add or remove outside

³ See John et al. (1992), Ofek (1993), Asquith et al. (1994), Brown et al. (1994), Mitchell and Mulherin (1996), Kang and Shivdasani (1997), Lai and Sudarsanam (1997), Denis and Kruse (2000), Baek et al. (2002), Faccio and Sengupta (2006), and Kang et al. (2010).

⁴ Expansion will be an effective strategy if it corresponds to a worthwhile investment opportunity, for instance, a strategic acquisition and a reinforcement of distribution channels as a reaction to declining sales (Kang and Shivdasani, 1997). Nevertheless, expansionary actions that represent diversification or that lead to loss of focus could be unfavorable to firm value (Jensen, 1986).

⁵ See John et al. (1992), Ofek (1993), Kang and Shivdasani (1997), Lai and Sudarsanam (1997), Denis and Kruse (2000), Baek et al. (2002), and Kang et al. (2010).

independent directors to or from its board.⁶ Fifth, firms conduct *external control activities*. These activities include takeovers, shareholder activism, and block purchases. Such activities are common among firms in the US where markets for corporate control are active, but are not common in countries that are not market-based economies (Kang and Shivdasani, 1997; Baek et al., 2002).⁷ Finally, many firms undertake *financial restructuring actions*. Financial restructurings include a dividend reduction or omission, debt restructuring, and raising of capital.⁸

If restructuring actions are an efficient response to an economic crisis or a fall in earnings, performance improvements should be observed after restructuring activities are undertaken. Also, among poorly performing firms, firms that restructure should improve their performance in subsequent periods to a greater extent than those that do not restructure. Consistent with the view that restructuring actions are beneficial to performance, investors generally consider corporate restructuring as good news. For instance, studies have shown positive and significant abnormal returns after troubled firms announce the replacement of a top executive (Bonnier and Bruner, 1989), asset restructuring (Hite et al., 1987; Khanna and Poulsen, 1995; Lang et al., 1995; Denis and Kruse, 2000; Baek et al., 2002; Baek et al., 2004), and an internal reorganization (Berger and Ofek, 1999; Baek et al., 2002). The market also reacts favorably to announcements of corporate restructuring to reduce costs and increase efficiency (Brickley and Van Drunen, 1990), and of employee layoffs as part of an overall restructuring plan to improve company efficiency (Khanna and Poulsen, 1995; Palmon et al., 1997) or after suffering a decline in operating performance (Nohria and Love, 1996).

However, investors do not always welcome announcements of expansion, especially those relating to diversification in firms where insiders might pursue their private benefits rather than value maximization. Baek et al. (2002) find that during the Korean financial crisis, chaebol firms that announce expansionary plans have a negative but insignificant abnormal

⁶ See Gilson (1989, 1990), John et al. (1992), Ofek (1993), Kang and Shivdasani (1997), Lai and Sudarsanam (1997), Denis and Kruse (2000), Baek et al. (2002).

⁷ See Mikkelsen and Partch (1989), Mitchell and Mulherin (1996), Denis and Kruse (2000).

⁸ See Gilson et al. (1990), John et al. (1992), Brown et al. (1993), Ofek (1993), Asquith et al. (1994), Mitchell and Mulherin (1996), Lai and Sudarsanam (1997), Faccio and Sengupta (2006).

return around the announcement date.⁹ The negative abnormal return becomes significant if the plans involve diversifying. In contrast, non-chaebol firms turn out to have a positive and significant return around the announcement date. But when the plans involve diversification, the market response is insignificant. This implies that diversification is not favorable for both types of firms.

The empirical findings discussed above indicate a favorable market reaction to the announcement of corporate restructuring, as long as the restructuring does not involve diversification. Hence, this evidence suggests that restructuring enhances firm value.

There is also evidence supporting the argument that firms restructure to improve stock price performance and accounting profitability. For example, John et al. (1992) find that changes in operations and levels of investments help companies to recover from negative earnings. Many studies find that firms engaging in asset sales have improved their operating performance in the periods that follow (John and Ofek, 1995; Kang and Shivdasani, 1997; Denis and Kruse, 2000; Baek et al., 2002; Kang et al., 2010). Firms also achieve improvements in their profitability following layoffs (Nohria and Love, 1996; Palmon et al., 1997; Kang and Shivdasani, 1997; Denis and Kruse, 2000; Baek et al., 2002; Kang et al., 2010). Likewise, internal control changes, in particular, the replacement of top management, play an important role in enhancing subsequent operating performance (Denis and Denis, 1995; Kang and Shivdasani, 1995). When financially distressed firms successfully restructure their debt out of court, their stock delivers significant positive abnormal returns (Gilson et al., 1990).

2.3 Bank connections and firm restructurings

Diamond (1994) provides an additional aspect of bank monitoring benefits, explaining that firms may prefer bank loans to public debt because banks could exercise control of debt over firms and help firms to save the costs of reorganization. If firms go bankrupt, banks will allow them to continue operations and invest in productive projects, whereas public debt holders will force them to liquidate.

⁹ A chaebol is a group of Korean companies that have close ties with each other.

The roles and benefits of bank relationships in monitoring and rescuing firms are often highlighted in the Japanese main bank system, which as Corbett (1987) explains, involves bank monitoring through regular visits, exchanges of information and exchanges of personnel between firms and banks. A screening process is carefully conducted by banks at the beginning of such relationships, and in the subsequent stages of long-term relationships, recurring monitoring is carried out to allow banks and firms to renegotiate loan contracts and to limit agency problems. Sheard (1989) additionally notes that in Japan, main banks actively take control and intervene in firms' business during reorganization by replacing incompetent managers with bank executives. Kaplan and Minton (1994) find that the likelihood of bank director appointments is higher in firms with negative income and is positively associated with the strength of bank relationships, measured by the proportion of bank lending.

Bulow and Shoven (1978) argue that main creditors may act in the equity holders' interests because they grant firms large loans. The main creditors possibly provide extra funds to help the firms avoid bankruptcy during financial distress periods. The findings of Hoshi et al. (1990) also show that main banks in Japan play a key role in rescuing financially-distressed firms and report that, after the periods of financial distress, the investment rate and sales growth of bank-connected firms are better maintained compared to those of firms without bank relationships. Aoki et al. (1994) and Sheard (1994), agree that in the system of the Japanese main banks, firms seem to be bailed out by their main banks that, typically, are major creditors and hold an ownership shareholding in firms. Thus, the main banks may have incentives to rescue connected firms by extending loans during periods of financial distress. Additionally, main banks are a substitute for courts in the formal bankruptcy process because the reorganization of firms is done informally between them and the financially-distressed firms.

In addition, bank connections were seen to be beneficial in protecting firms against the possibility of filing for bankruptcy during the East Asian crisis. Claessens et al. (2003) find that firms, which are owned by banks, have a lower possibility of filing for bankruptcy. Bank connections contribute to advantages in terms of information and resource allocation in rescuing firms, and out-of-court renegotiations seem to take place informally to reduce the likelihood of bankruptcy. Furthermore, banks can often be a part of business groups and are known for giving group-affiliated firms preferential access to capital, particularly for the firms in distress. This group membership of banks also makes bank-led creditor workouts

easier for group-affiliated firms. Moreover, negotiations between a distressed firm and its creditors are an important consideration in the resolution of distress (Faccio and Sengupta, 2006).

As reviewed above, we hypothesize that bank connections increase the likelihood of firm restructuring. The connected banks appear to closely monitor firms and provide financial advices during a crisis, when a useful financial strategy, i.e. restructuring, is needed to turnaround the company. Moreover, we expect that if bank connections are valuable to firms, connected firms should have better performance changes than non-connected firms after restructurings.

2.4 Other significant factors and firm restructurings

In addition to the major attributes of bank connections discussed in the last section, the literature points out that business group affiliation, size, leverage, firm and industry performances and liquidity are also significant factors that determine the likelihood of restructuring. To precisely investigate the effects of bank connections on firm restructuring, these factors are introduced as control variables in probit models to be discussed in the next chapter.

2.4.1 Business groups

The results of existing studies on the costs and benefits associated with business group affiliation have been mixed. One of the advantages brought by group affiliation is that business groups provide internal markets among member firms. This advantage explains why business groups are more pronounced in emerging economies. Due to a high degree of information asymmetries, a lack of intermediary institutions, and imperfections in capital, product, as well as labor markets, firms in emerging economies find it costly to acquire essential resources and also to establish corporate reputation and credibility (Khanna and Palepu, 2000). Business groups can help mitigate these problems through their internal markets.

However, the complicated ownership and control structures of business groups may increase the severity of any agency problems (Lins and Servaes, 2002; Claesses et al., 2002). Since business groups typically consist of firms ultimately controlled by a family, linked together via pyramids or cross-shareholdings, the major conflicts arise between controlling families

and minority shareholders. Large scale and scope of business groups and high informational asymmetries facilitate the expropriation of outside minority shareholders by owner-managers. Inefficient transfers of resources across group members and unproductive investments in a business group are related to the agency issues described above (Scharfstein, 1998; Shin and Stulz, 1998; Rajan et al., 2000; Scharfstein and Stein, 2000).

The effects of group affiliation on firm restructurings in response to a crisis are unclear. On the one hand, business groups often provide sufficient cross-guarantees to bail out group-affiliated firms in distress. Group affiliation can also dilute the information available to an outside creditor. In crisis, this opacity may help group-affiliated firms as there is a greater likelihood of being bailed out by creditors (Morck et al., 2005). Hence, conglomeration can be designed as a mechanism to maximize the chance of bailout in the event of a default on bank loans (Kim, 2004). In addition, if controlling shareholders of business groups effectively and vigorously get involved in managerial decision-making on restructuring policies, group firms should be more likely to engage in restructuring actions, relative to non-group firms. On the other hand, if controlling shareholders focus on maximizing scale and scope of the group as opposed to the value of individual affiliated firms, even in a time of crisis, downsizing may occur less often or expansion may occur more often in group firms.

Empirical studies on the impact of group affiliation on restructuring are limited. Hoshi et al. (1990) show that Japanese firms affiliated with a keiretsu, invest more after financial distress, relative to non-affiliated firms. Kang and Shivdasani (1997) find that poorly performing firms belonging to a keiretsu are less likely to layoff staff or replace their previous top executives with outsiders. The lower likelihood of outside succession in keiretsu firms is also consistent with Kang and Shivdasani (1995). Unlike Hoshi et al. (1990), Kang and Shivdasani (1997) document no significant effect of keiretsu affiliation on the incidence of expansion in distressed firms. Considering an economic crisis, Baek et al. (2002) show that Korean group firms engage in downsizing actions (i.e., asset downsizing or employment layoff) and internal reorganization less frequently, while they implement expansionary actions (without downsizing) more frequently, than non-group firms. However, chaebol firms in which owner-managers hold high ownership stake are less likely to downsize but are more likely to expand during the Korean financial crisis. Based on the mixed results, the relationship between business group affiliation and firm restructuring remains an empirical issue.

2.4.2 Size

Although it is not clear how firm size affects restructuring activities, evidence from previous studies reveals a positive relationship between firm size and the incidence of restructuring. Kang and Shivdasani (1997) and Baek et al. (2002) contend that since large firms have more assets and a greater number of employees, they are more likely to undertake such actions as asset sales and staff layoffs, relative to small firms. On the other hand, because large firms are well established with large asset bases that can be used as collateral, they usually have a better access to external sources of funds. Hence, large firms could engage more in expansionary actions and capital raising. Faccio and Sengupta (2006) also argue that the choice for a workout is likely to depend on firm size and borrowing capability. Alternatively, Ofek (1993) argues that a positive relationship between firm size and the likelihood of operational restructuring may reflect the fact that large firms have a greater ability to restructure at the beginning of distress, relative to small firms.

2.4.3 Leverage

Jensen (1989) argues that debt can be used as an alternative governance mechanism, in particular when a board of directors fails to monitor management. For highly leveraged firms, a slight decrease in firm value may lead to default on debt obligation. Thus, firms with a high level of debt are likely to respond more rapidly to a crisis. In a similar vein, Wruck (1990) argues that with low leverage, managers of poorly performing firms may not realize a distress situation, and hence a need to restructure. Accordingly, no organizational changes are triggered. It is leverage, and in turn financial distress, that provide creditors with incentives to monitor and the right to demand a firm in difficulty to restructure quickly and efficiently.

Jensen (1986) and Stulz (1990) argue that debtholders prefer restructuring actions that generate cash flows to facilitate debt services, such as asset sales and operational divestments. In addition, debtholders tend to favor dividend reduction or omission to retain cash, and equity issuance to increase liquidity (Storey et al., 1987). Monitoring by debtholders is also likely to induce managers to undertake value-maximizing actions, implying a positive relationship between leverage and the probability of terminating unprofitable units, laying off staff, and replacing incompetent managers. Kang et al. (2010) document that the disciplinary role of debt becomes valuable when the agency problem of controlling shareholders is severe; i.e., when firms are in an economic crisis.

Findings from previous studies support these views. Lang et al. (1995) show that US firms engaging in asset sales are inclined to have high leverage. Ofek (1993) finds that US firms with a high level of debt respond to poor performance more quickly, relative to those with a low level of debt. Specifically, a greater use of debt increases the probability of all restructuring actions in his study, except for top executive turnover. Lai and Sudarsanam (1997) find a positive association between the level of debt and the probability of cash-generative actions and debt restructuring in UK firms. Kang and Shivdasani (1997) show that, among Japanese firms, leverage has a positive impact on acquisition but a negative impact on downsizing actions. Using Korean data during the East Asian financial crisis, Baek et al. (2002) document a positive relationship between leverage and the likelihood of changes in internal control, and a negative relationship between leverage and the likelihood of firms being taken over. Faccio and Sengupta (2006) find that East Asian firms with high leverage are more likely to restructure by asset sales and debt workouts in response to the economic crisis.

Negative or insignificant effects of leverage on the likelihood of restructuring cast doubt on corporate governance roles played by debtholders. A number of studies show that connected lending is common in emerging markets where arm-length contracting is not reliable due to the ineffectiveness of formal institutions in emerging market firms (for example, Laeven, 2001; La Porta et al., 2003; Charumilind et al., 2006). Firms could obtain credits, especially long-term borrowings, mainly because their managers or controlling shareholders have close relationships with creditors. Such strong connections between firms and debtholders could impair the importance of debt in corporate governance of emerging market firms.

Viewed collectively, a use of debt as a governance mechanism and connected lending often documented in emerging economies make the effects of leverage on the likelihood of restructuring actions unclear. Leverage is thus introduced as one of explanatory variables to investigate these issues.

2.4.4 Firm and industry performances

Firms that perform poorly are expected to be more likely to restructure. The empirical evidence shows that firm performance does have a significant effect on the probability of restructuring actions. However, this evidence is also mixed as to whether firm performance

impacts positively or negatively on the likelihood of the firm undertaking any restructuring actions.

Ofek (1993) documents a marginal positive relationship between annual stock returns and the likelihood that US poorly performing firms sell assets or make dividend cuts. In contrast, Kang and Shivdasani (1997) find that returns on assets are negatively associated with the likelihood of downsizing in both Japanese and US firms that suffer a substantial performance decline. In line with Kang and Shivdasani (1997), Morck et al. (1989) show that the likelihood of top executive turnover is lower in firms that outperform their industry standard. Denis and Kruse (2000), however, find no impact of a change in returns on assets on corporate restructuring. As for firms in an economic crisis, Baek et al. (2002) show that higher holding period returns decrease the probability of downsizing and internal reorganization taken by Korean firms.

Evidence on the importance of industry performance is also provided. Kang and Shivdasani (1997) document a positive relationship between industry performance and the probability of expansion in Japanese firms. They explain that firms tend to acquire more assets when their industry is performing well. They also report that for US firms, industry performance is positively associated with the likelihood of downsizing. This result is in line with Shleifer and Vishny (1992) who argue that firms are less inclined to sell assets if their industry condition is poor. In general, Mitchell and Mulherin (1996) find that the magnitude of takeover and restructuring activities is varied across industries, depending on the magnitude of an economic shock borne by industries. To control for significant factors that determine firm restructuring, the abovementioned variables are incorporated in multivariate probit models. However, past studies show that the relationships between these variables and the likelihood of restructuring actions are not conclusive. The effects of such variables are an empirical issue that this study investigates.

2.4.5 Liquidity

Firms with more liquid assets are generally less financially constrained. This suggests low demand for external sources of funds to finance losses in firms with high liquidity, at least in the short run. Accordingly, the probability that these firms will engage in restructuring actions such as asset sales, staff layoffs, debt restructuring, and new financial security issuance, might be smaller. Ofek (1993) and Baek et al. (2002) find that firm liquidity is

inversely related to the likelihood of downsizing. Baek et al. (2002) also show a negative relationship between liquidity and the likelihood of firms being taken over. In addition, DeAngelo et al. (2002) argue that in firms with highly liquid asset structures, the role of leverage as a governance mechanism could be reduced since “managers of troubled firms can utilize excess assets to fund losses and meet interest payments while experimenting with risky strategies that might (or might not) turn out to be profitable” (p. 21).

