

This is a repository copy of *Corporate governance and financial constraints on strategic turnarounds*.

White Rose Research Online URL for this paper:
<https://eprints.whiterose.ac.uk/1420/>

Article:

Toms, S. and Filatotchev, I. (2006) Corporate governance and financial constraints on strategic turnarounds. *Journal of Management Studies*. pp. 407-433. ISSN 1467-6486

<https://doi.org/10.1111/j.1467-6486.2006.00596.x>

Reuse

Items deposited in White Rose Research Online are protected by copyright, with all rights reserved unless indicated otherwise. They may be downloaded and/or printed for private study, or other acts as permitted by national copyright laws. The publisher or other rights holders may allow further reproduction and re-use of the full text version. This is indicated by the licence information on the White Rose Research Online record for the item.

Takedown

If you consider content in White Rose Research Online to be in breach of UK law, please notify us by emailing eprints@whiterose.ac.uk including the URL of the record and the reason for the withdrawal request.



White Rose
university consortium
Universities of Leeds, Sheffield & York

White Rose Consortium ePrints Repository

<http://eprints.whiterose.ac.uk/>

This is an author produced version of a paper published in **Journal of Management Studies**.

White Rose Repository URL for this paper:
<http://eprints.whiterose.ac.uk/archive/1420/>

Published paper

Filatotchev, Igor and Toms, Steven (2006) *Corporate governance and financial constraints on strategic turnarounds*. *Journal of Management Studies*, 43 (3). pp. 407-433.

Corporate Governance and Financial Constraints on Strategic Turnarounds

By

IGOR FILATOTCHEV
King's College London
150 Stamford Street, London SE1 9NN
Tel/Fax: +44-207-8483965
e-mail: igor.filatotchev@kcl.ac.uk

and

STEVE TOMS**
Department of Management Studies
Sally Baldwin Buildings
University of York
York YO10 5DD
Tel: +44-1904-434122
Email: st27@york.ac.uk

* An earlier version of this paper was presented at a conference on the 'Corporate Governance Life-Cycle: The Research Agenda and Practical Implications ' 10-11 April 2003, Bradford, UK University of Bradford School of Management, and Business Policy and Strategy Division of the Academy of Management Annual Conference, August 2004, New Orleans, USA . We are grateful to Mike Wright, the editor and three anonymous referees for their insightful comments.

** Corresponding author

Word count: c.12,000

Corporate Governance and Financial Constraints on Strategic Turnarounds

Abstract

The paper extends the Robbins and Pearce (1992) two-stage turnaround response model to include governance factors. In addition to the retrenchment and recovery, the paper proposes the addition of a realignment stage, referring specifically to the re-alignment of expectations of principal and agent groups. The realignment stage imposes a threshold that must be crossed before the retrenchment and hence recovery stage can be entered. Crossing this threshold is problematic to the extent that the interests of governance-stakeholder groups diverge in a crisis situation. The severity of the crisis impacts on the bases of strategy contingent asset valuation leading to the fragmentation of stakeholder interests. In some cases the consequence may be that management are prevented from carrying out turnarounds by governance constraints. The paper uses a case study to illustrate these dynamics, and like the Robbins and Pearce study, it focuses on the textile industry. A longitudinal approach is used to show the impact of the removal of governance constraints. The empirical evidence suggests that such financial constraints become less serious to the extent that there is a functioning market for corporate control. Building on governance research and turnaround literature, the paper also outlines the general case necessary and sufficient conditions for successful turnarounds.

Corporate Governance, Financial Constraints and Strategic Turnarounds

INTRODUCTION

In their seminal article Robbins and Pearce (1992) suggest a two-stage turnaround model that has recently attracted a lot of attention in academic and practitioner literature. According to this framework, a turnaround situation arises when performance criteria are sufficiently depressed to warrant a turnaround response. A turnaround response consists of activities likely to overcome the firm's troubles and return it to match or exceed prior performance. The response consists of a retrenchment stage that might comprise "restructuring", "downsizing" and "downscoping", with a particularly strong emphasis on cost and asset reduction required for mitigation of the conditions responsible for the financial downturn. As a firm achieves stability it moves to the second stage of turnaround and engages "recovery response" strategies, which may include new market entries, mergers and acquisitions, new product development, etc (Robbins and Pearce, 1992, pp.306-307).

However, such outcomes presuppose that entry into the first recovery stage is unproblematic. In this paper, we argue that there are important *ex ante* conditions that must be present in order that managers might enter the retrenchment stage. Specifically, managers must gain the support of finance providers for the proposed strategy and, as part of the process, realign profit expectations notwithstanding differences in short and longer run outcomes, so that there is a consensus of objectives between principal and agent groups. By introducing this additional turnaround stage, referred to below as the "re-alignment" stage, the paper extends the Robbins and Pearce (1992) model.

More recent research on turnaround suggests that the performance outcomes of asset and cost retrenchment are contingent on industry dynamics, which, in turn, affects the

underlying value of the firm's assets (Morrow et al., 2004). This paper extends these arguments further and makes a contribution by suggesting that financial constraints on turnarounds may represent important factors affecting the success of this strategy. These constraints are linked to capital structure and differential expectations about financial returns among governance groups.

The strategy research literature has tended to neglect the financial aspects of turnarounds. Even so, financial distress, which occurs where firms fail to maintain their capital and hence the value of the claims of financial stakeholders, might be expected to be an important feature of most (if not all) strategic crises faced by business organizations. The contention of this paper is that turnarounds cannot be sensibly analysed without taking into account the context of the financial obligations and related governance arrangements.

There are many cases where retrenchment is possible and indeed made easier for management when the onset of a crisis provides justification for unpopular decisions (Grinyer et al., 1988, p.95), but as this paper illustrates, this is not always the case. Where it is not, there will be a failure of an important necessary condition for turnaround success. Specifically, if the turnaround model is extended to include financial constraints and governance factors, allowing for their impact on managerial flexibility and turnaround performance (Jensen, 1986; Morrow et al., 2004), there are circumstances in which they may have the effect of preventing entirely the pursuit of all subsequent strategic options. The reasons why financial arrangements may impose serious constraints on such strategic options are twofold. These are explained in detail below. In summary they arise first because financial structure imposes fixed costs that are accordingly difficult to reduce without altering ownership rights. Secondly because in a crisis there might be a greater economic benefit to owners from the continued employment of all deployed assets relative to the opportunity benefit of turnaround strategies (Morrow et al, 2004), and asset sales are linked directly to

reordering of financial claims in circumstances of financial distress. Finally, the development of the market for corporate control (MCC) may increase the probability of firms adopting turnaround strategies since it increases the potential exit benefits to existing shareholders and provides financial resources during the recovery stage. The MCC refers to the existence of conditions, for example liquid share markets, transparent and flexible managerial labour markets, appropriate institutions of financial intermediation, promoting the realization of the collective value of the firm's assets (Hitt et al., 1996).

Whereas many of the studies referred to above have used the individual firm, the current study also uses the industry as the unit of analysis. An important reason is that the paper develops strategic factor market (SFM) theory to explain asset values at the industry level. In the SFM approach such values can be related to normal economic returns, but also to accommodate the expectation that such asset values are influenced by industry level effects, particularly capacity utilization.

The principal motivations of this paper therefore are threefold. Firstly, it aims to assess the importance of financial constraints as explanatory factors in the success or otherwise of corporate turnarounds. Secondly the paper aims to show that there are circumstances where financial constraints arising from crisis situations may impose a hard constraint on other strategic options, thereby preventing endogenous turnaround regardless of the attitudes, competencies and strategies of incumbent management. In other words, although prior studies emphasised managerial inaction as an important cause of turnaround failure (e.g. Barker and Mone, 1994; Hambrick and Schecter, 1983; Hofer, 1980; Schendel, et al. 1976; Weitzel and Jonsson, 1989), inaction may not in itself be the product of poor management, particularly where financial constraints operate. Thirdly, whilst recognizing that finance, but not strategy, based research identifies financial restructuring as an integral component of turnarounds (e.g. Brown, et al., 1993; DeAngelo and DeAngelo, 1990; Franks and Tourous,

1994; Gilson, 1989; John, et al., 1992), the paper shows that strategic and financial aspects of turnarounds are inseparable. To examine these propositions the remainder of the paper is divided into three further sections. The first develops a theoretical model explaining circumstances in which it might be expected that financial constraints impact directly on strategic decisions. The second examines an empirical case providing an exemplification of failure to restructure under hard financial constraints. The final section draws conclusions.

A GOVERNANCE BASED-MODEL OF TURNAROUNDS

Previous strategy research on the turnaround process commonly focuses on pre-identified stages. For example these might be the efficiency driven operating turnaround stages and entrepreneurially driven strategic recovery stages (e.g. Bibeault, 1982; Robbins and Pearce, 1992; Slatter, 1984). These response stages are linked to the process of organizational decline and crisis, and related to the incidence of internal and external causes (Barker and Duhaime, 1997; Bruton et al., 2003). External causes are related to environmental changes that make the firm's existing strategy inappropriate, whereas internal sources of decline are associated with managerial error (Barker and Duhaime, 1997). Some authors indicate that both sources of decline may overlap (De Witt, 1998) demanding a complex managerial response in terms of operating solutions (e.g., retrenchment) and strategic solutions (asset reconfiguration, market re-positioning, etc.).

Whilst there is consensus on these elements of the turnaround process, there has been considerable debate about the importance of business turnaround strategies in the strategic restructuring and "re-invention" process (see Filatotchev et al., 2000, for a review). Barker and Mone, (1994, p.395) suggest that retrenchment is not a cause of turnaround performance but rather a consequence of a steep performance decline during which a firm's financial

performance is extremely poor, an assumption supported by Barker and Duhaime (1997). There is also debate about whether such retrenchment strategies are necessary conditions at all as precursors for subsequent strategic turnaround actions (Castrogiovanni and Bruton, 2000). According to the latter view, strategic actions may be sufficient for successful turnarounds in some contexts and recourse to retrenchment strategies may be unnecessary or even counter-productive (Hoskisson and Hitt, 1994; Schreuder et al., 1991). Any attempt to extend the Robbins and Pearce stage-based approach must also deal with these criticisms.

A general defect of all existing approaches in the strategy literature is the relative absence of research on the financial aspects of turnaround (Morrow et al., 2004). Both agency (e.g., Jensen, 1986; 1993) and strategic management (e.g., Kochhar, 1996; Kochhar and Hitt, 1998) research acknowledges that the structure of financial liabilities and related governance aspects may have an important impact on the firm's strategic decisions. Jensen suggests that "changes in financial and governance policies generate value-creating changes in behaviour of managers and employees" (Jensen, 1993, p.869), emphasising the governance role of debt-holders. Kochhar and Hitt (1998) find strong reciprocal links between the firm's capital structure and corporate strategies, such as acquisitions and product diversification. Kochhar (1996) has developed a theoretical model that brings together analysis of capital structure, firm resources and strategic decisions and recent research has increasingly acknowledged the importance of governance factors as a constraint on managerial activity as part of the turnaround process (Daily and Dalton, 1998).

Whilst the Robbins and Pearce (1992) framework is a useful starting point, it is therefore underdeveloped in certain respects. Specifically, their arguments that, depending on the severity of the crisis, strategic repositioning must be preceded by cost reduction or asset sales is underpinned by the assumption that these financial strategies exist freely as options in all cases. Robbins and Pearce (1992) and other studies (e.g., Hambrick and Schechter, 1983;

Slatter, 1984; Grinyer, et al 1988, Grinyer and McKiernan, 1990) recognize the importance of retrenchment, they assume it to be an outcome of managers' rational strategic response to organizational crisis. The contention of this paper is that the introduction of governance-based constraints restricts the availability of these options and can have a decisive impact on the turnaround process.

To consider strategic resources and their allocation through governance mechanisms in tandem, a strategic model is developed in this section, in which several further strands of theory are synthesised. These are strategic factor market (SFM) theory, corporate governance and accounting analysis of asset valuation and determination of financial returns. Combining these elements, a model, summarized in figure 1, can be used to analyse the turnaround process.

Figure 1 about here

The first layer in figure 1 presents three stages of the turnaround process. Stage 1 is an addition to the standard turnaround model, stressing the importance of existing governance arrangements and, in particular, the requirement for a *re-alignment* of expectations and strategic objectives of managers and external investors (equity holders and banks). Stages 2 and 3 broadly correspond to the Robbins and Pearce (1992) model of strategic turnaround. Moving from left to right, successful completion of the first stage is a necessary condition for commencing the next, so that for each there is a financial constraint in the second layer and a strategic outcome in the third layer, which depends on the completion of each respective stage.

The second layer in figure 1 refers to evaluations by shareholders and debt-holders of rates of return, as well as the revenue generated by possible asset disposals, which, in turn,

depend upon profit rates and asset valuations consistent with each of the three turnaround stages and strategic outcomes. The transparency of these processes influences the effectiveness of monitoring by financial stakeholders and their evaluation of the likely financial and strategic outcomes of each turnaround stage. Where the expected rate of return (ER) of the managerial turnaround strategy is less than the investors' required rate of return (R), and expected realizable value (NRV) is less than book value (BV) of assets, there is no benefit for stakeholders in supporting managerial strategic decisions. NRV depends on the present resale market value of assets whilst BV is the discounted sum of the expected stream of profits from continued deployment. At stage 1, therefore, there is pressure to re-align interests and expectations of managers and financial stakeholders, so that these converge. Successful completion of stage 2 requires net realizable value (NRV) to equal or exceed book value (BV). Finally, where ER is greater than R it is rational to enter or invest (Edwards, et al., 1987). These are also necessary conditions respectively for the completion of stage 3 and the overall transition through the re-alignment and retrenchment stages to a successful turnaround.

The corresponding strategic outcomes in the third layer of figure 1 correspond to the appropriate turnaround stage. Failure to complete the first, re-alignment stage, results in strategic outcome 1, a continuation or "do nothing" strategy, with rate of profit expectations based on the BV of invested capital. Such an outcome is likely where BV exceeds the NRV of asset disposals. The second, retrenchment, stage requires some realization of invested capital, for example through disposal of old assets, exit from unprofitable segments and other downsizing activities, so that funds are available to finance the recovery strategy. For success in this stage, it is necessary that NRV exceed BV. If the condition is not met, there will be a reversion to the "do nothing" strategy. Expected returns from reinvestment of the proceeds from asset sales must then exceed the required rate of return, or if not, downsizing or

complete exit becomes the realized strategy. Only if both of these stages are complete can firms attempt the third stage recovery stage. Entering this stage is of course no guarantee of turnaround success, which depends on the expected and later actual returns exceeding the required rate of return once investments in new assets have been made.

Each element of the model in figure 1 depends on an interpretation and synthesis of different elements of theory, which are now discussed in turn.

Strategic factor markets

SFM theory offers a theoretical basis for rationalizing decisions, common to turnaround situations, to enter or exit specific activities and markets or market segments. It is a means of analysing the cost of acquiring new resources required to support the firm's product market strategy (Barney, 1986) or in a turnaround situation it might be extended to consider the value of asset disposals (Morrow et al. 2004). The benchmark comparative is the economic value of an asset where SFMs are perfectly competitive (Barney, 1986). Imperfections in such markets will be reflected in higher entry costs, for example where the acquisition of the appropriate technology is expensive in the case of turnarounds (Morrow et al, 2004) By extension, SFMs create exit barriers where the asset resale market is thin.

For Barney (1986, pp.1231-2, 1236-7) the MCC and capital sources are also SMFs. The model in figure 1 extends Barney's (1986) approach to offer a financial dependency perspective to incorporating differential evaluations of strategic options and their expected profits from the perspectives of managers, shareholders and debt holders. In crisis situations, this governance component of the model is particularly important, as the views of the non-managerial groups about asset valuation and prospective profit streams are of great importance, impacting on the employment or withdrawal of capital. Also important is the

degree of consensus or divergence in expectation between principal and agent. As argued above, divergence may prevent turnaround and consensus may be a necessary condition for turnaround. Figure 1 reflects these relationships by suggesting that managerial decisions about the turnaround process are endorsed or contradicted by external finance providers.

Governance arrangements

Previous research linking capital structure and the firm's strategy decisions acknowledges that information asymmetries between incumbent managers and external providers of finance create agency costs (Kochhar, 1996). Without reliable data on the new strategy's risk and value outcomes, finance suppliers will be either unwilling to fund new strategic projects, or charge higher premiums because of the potential for adverse selection and moral hazard (Kochhar and Hitt, 1998, p.603). However, notwithstanding differential access to information, it is also possible for these expectations to converge so that principal and agent groups agree on the strategic choice, particularly in the case of the tripartite discrete choices offered in figure 1. Insofar as principals do not support a particular choice where it might otherwise be rational, the governance structure constitutes an exit barrier. Bearing in mind information asymmetries and related risk problems, external financiers may use their voice-based governance powers to favour strategies with less potential upside but lower risk associated with them, and this direct strategic involvement may be driven by limitations on their ability to diversify their investments. Intervention by capital suppliers utilizing governance mechanisms is more likely and may be more effective when the base of asset valuation alters, because owners and managers will simultaneously seek new information about asset valuations in the new circumstances.¹

Corporate governance research may accordingly be extended further by taking into account industry dynamics and inherited governance mechanisms that have evolved at previous stages of industry development (Cameron and Whetten, 1981; Quinn and Cameron, 1983). More specifically, because of their inherent inertia, governance arrangements that have evolved as a result of financing rounds at the growth stage may create substantial strategic barriers when industry's fortunes change (Arthur, 1989). Some researchers have recognized potential governance constraints on managerial incentives to design and implement strategic restructuring in declining industries (e.g., Filatotchev and Toms, 2003; Hambrick and D'Aveni, 1992). In this paper we develop this framework further by suggesting that restructuring barriers may also be explained by financial constraints associated with governance factors.

In conditions of uncertainty and heightened information asymmetry, managers and owners may evaluate these opportunities differently, and their preferences with respect to strategic options may not coincide even when managers are not engaged in self-serving behaviour (Sanders and Carpenter, 1998). In addition to differences in expectations, managers and external investors may have different time horizons which may have further impact on their strategic preferences (Bethel and Liebeskind, 1993; Brickley et al., 1988; Kochar and Hitt, 1998). More precisely, where BV is greater than NRV, principals' views are more likely to converge on the steady state strategy and non-entry of the subsequent stages, even though managers may advocate retrenchment in the expectation of a subsequent long-run turnaround.

Taking these factors together, the conditional availability or non-availability of finance may under certain conditions act as an entry barrier (Jensen, 1986; 1993). Similarly in conditions of industry decline, exit decisions will be mediated by corporate finance and accountability factors. Whether or not firms downsize and/or exit will depend in part on whether the NRV of assets allows financial stakeholders to liquidate their position without loss of capital. If such values are low compared to the value of profit streams from continued use,

then active monitoring by financial stakeholders may prevent retrenchment (Jensen, 1993). The governance and financial performance link is a further important aspect of these relationships.

In terms of governance factors, the relationship between shareholders, debt-holders and managers in figure 1 depends on voice-based governance mechanisms and the presence of a liquid share market including the MCC (DeAngelo and DeAngelo, 1990; Eisenhardt, 1998; Franks and Mayer, 1997; Hart, 1995; Jensen, 1986; 1993). These are the observable outcomes of complex interactions of these governance arrangements, which rely on different channels of monitoring and control. Voice-based governance, for example, relies on boards of directors and their committees that perform their fiduciary duty to ensure managers maximize value for shareholders (e.g., Hoskisson et al., 1994; Kochhar, 1996), or direct influence of large-block shareholders who have enough power to control managerial discretion (e.g. Schleifer and Vishny, 1986). More recent research, however, indicates that institutional investors may have different investment objectives (Hoskisson et al., 2002)². A number of authors emphasise an increasing governance role for debt holders who may have a superior access to the firm's information (Jensen, 1993; Citron et al., 1997; 2003), particularly in countries with "relationship" governance systems such as Japan (Kim and Hoskisson, 1996).

Financial returns

Theoretical models show that economic profit reconciles to cash flows generated by an asset or group of assets in any given time period and the difference in their opening and closing valuations (Edwards and Bell, 1961, Edey, 1962). It follows that strategic entry and exit decisions can be related to level of profit and asset valuation (Edwards, et al., 1987; Shleifer and Vishny, 1992). Replacement cost (RC), BV and NRV, reflect in turn differences in value between new technology and deployed assets and between historic cost and current market

values. Firm specific risk associated with each strategy is higher in a crisis and it becomes more likely that expectations will diverge between principals and agents, so that entry into the re-alignment stage is problematic. In turnarounds, asset values, which change according to intended use, and act as collateral, are also important inputs into governance groups', including particularly debt-holders', decisions about whether to endorse or sanction strategic redirection.

Another way in which investors' attitudes change is if existing assets are under-utilized, either through temporary changes in demand or through longer-run over-capacity problems. In such cases, losses are incurred as a result of spreading fewer units of output over a higher cost base. In certain conditions of asset specificity, managers have an incentive to diversify the uses of such assets (Teece, 1980). In conditions of changing technology, capital losses arising from obsolescence may be also expressed as asymmetries between NRV and BV of assets on the assumption of continuing use. Further, declining realizable values of specific assets may create exit barriers where their use can be continued at low marginal but high average cost, for example in conditions of excess capacity.

The final point of reference in figure 1 influencing the relationship between managers' strategic decisions and external financiers is ER. As already noted, profit levels will affect deployed asset values as differentially perceived by external stakeholders. A further important aspect impacting on ER in figure 1 is the firm's cost structure. Where industries are affected by downturns and crisis conditions the firm's cost base, and the impact of costs not easily variable in the short run will be a crucial determinant of both expected profit and the ability of managers to stabilize cash flows. Fixed costs typically arise from sunk and specialized assets, which are sources of entry barriers and competitive advantage under the assumptions of SFM theory. A further possibility, investigated below, is that the fixed cost structure acts as an exit barrier where the fixed costs themselves arise from restructuring.

Synthesis and extensions

Our arguments underpinning the theoretical model in figure 1 suggest that external financiers may impose constraints on managerial turnaround decisions. When their expected returns and net realizable value of asset sales are less than required rate of return and book value respectively, they will use governance channels to force managers to preserve *status quo*. Retrenchment actions may be taken when investors expect that assets sales will generate revenue higher than their existing book value. Finally, expected returns from investment at the recovery stage must exceed the required rate of return, or if not, downsizing or complete exit becomes the realized strategy. However, our model has a number of important internal and external contingency factors, such as presence of an MCC and financial structure of the firm.

The MCC is a SFM, in which differential expectations about future financial returns lead to overpayment by acquiring firms thereby creating acquisition premiums.³ The MCC utilizes all three valuation reference points in figure 1, where acquisition motives vary from accessing new and difficult to replicate assets, obtaining new streams of cash flow, or purchasing bundles of assets with high separate realization potential. Where demand for new finance is high, for example where technical development is rapid, there will be pressures to alter governance, accountability and reporting structures in favour of outside financial stakeholders. All these governance mechanisms are important since they facilitate the rational comparison of financial outcomes from the strategic options faced by current financial stakeholders. The combined potential effect of these governance factors on the probability of turnaround success is illustrated in figure 2.

Figure 2 about here

As figure 2 suggests the presence of a MCC is likely to promote turnaround opportunities, since it increases the potential realizability of exit values and also offers new financing opportunities during the recovery stage. With no MCC, there is no reason why book values should not exceed market values or vice versa, since exit values can only reflect the break-up value of the corporation. The positive impact of developed capital markets on strategic restructuring has been acknowledged both in the strategy and corporate finance literatures (e.g., Brickley, et al., 1988; Doukas and Travlos, 1988; Eisenhardt, 1989).

Alignment between asset base and financing arrangements is also likely to impact directly on turnaround capacity. Some researchers recognize different impacts on turnaround strategy associated with equity as opposed to debt financing (Kochhar, 1996). In theory, banks have a priority in repayment in turnarounds and restructuring⁴. Given that banks are first in the queue, there may be incentives for banks to wind things up to recover some value, even where shareholders might persist, with positive consequences for restructuring and capacity reduction.⁵ However, banks are also exposed to financial constraints related to asset valuation. Whereas bank loans are secured against replacement value of the assets, in a bankruptcy banks recover a liquidation value (Morrow et al., 2004)⁶. A study by Franks and Mayer (1997), for example, provides evidence that debt-related governance has been a handicap in achieving downward adjustments (i.e. labour and plant downsizing) during an international economic slowdown.⁷ Problems with restructuring of South Korean *chaebols* can be used as an example of banks putting good money after bad in a situation when they can recover only a fraction of the original loan to a struggling company.⁸ There may thus be a failure to exit from non-viable projects in a timely fashion. Financial economists also recognize that financial structure of the firm and governance roles of debt and equity

providers may have an important impact on organizational responses to performance decline (Aghion and Bolton, 1992; Hart, 1995; Grossman and Hart, 1995). Although there may be tax advantages to debt finance in some circumstances normal priorities for financial claims increase bankruptcy risk from the perspective of residual equity stakeholders (Altman, 1984), and by corollary reduce the probability of turnaround. For these reasons, figure 2 suggests a probability continuum, where turnaround probability is promoted by the existence of a MCC and within each set of institutional arrangements in general is higher where debt is lower.

The relationships suggested in figure 1 and 2 offer several advantages in the analysis of strategic decision-making discussed above. To begin with, they present a logical framework for the analysis of financial performance using accounting data. Although the determination of performance is important in the fields of strategic management (Ketchen et al, 2004) and industrial organization, many economists are reluctant to use accounting data due to its perceived lack of reliability (Mueller, 1990, Schmalansee and Willig, 1991). However, the Edwards et al. (1987) analysis, whose assumptions are integrated into the model, suggests an analytical solution to these problems provided appropriate valuation rules are followed. Whilst financial performance may be a worthwhile measure for evaluating strategic outcomes, it is also useful for analysing the effectiveness of governance systems. For example, the MCC can be analysed with reference to wealth effects, where the distribution of gains from merger transactions is a function of differences in RC, BV and NRV. Finally, the framework is consistent with recent developments in financial theory, which has shifted emphasis from the value irrelevance of capital structure and dividend decisions to the relationships between active or passive investor monitoring arrangements and the value of the firm (Jensen, 1993). These relationships are increasingly recognized elsewhere, particularly in comparative and historical analysis of governance systems (Whittington and Mayer, 2000, p.13-14).

FINANCIAL CONSTRAINTS ON TURNAROUND: EMPIRICAL EVIDENCE

Research methodology

Researchers of organizational decline propose that the roots of a firm's decline can either be based in an industry downturn or be based in firm-specific problems (Cameron et al., 1987). Industry-based decline occurs when "a firm's industry shrinks in size or munificence, reducing the number of firms the industry can support and causing the firm and many of the other firms in the industry to suffer performance declines" (Barker and Duhaime, 1997: 18). As opposed to firm-level declines caused by managerial strategic mistakes, industry-based decline creates a homogenous population of struggling firms, and this makes causal links between firm-level performance and business turnaround strategy less ambiguous (Cameron and Whetten, 1981). Morrow et al. (2004) also suggest that industry dynamics may play an important moderating role in terms of the relationship between retrenchment and firm's performance.

Building on these arguments, we chose the British textile industry as an empirical illustration of the theoretical model for a number of reasons. First, the industry is endemically cyclical and therefore presents frequent opportunities through time and in different international and institutional settings to analyse survival threats and managerial response. Second, whereas turnarounds in the US textile industry have been examined elsewhere (Jensen, 1993; Robbins and Pearce, 1992), the depression that affected the British textile industry was more serious, and the British case therefore provides a useful test of the limits of existing models suggested in the above discussion. Two particular cases, the slump of the 1920s and the corporate restructuring from the 1960s onwards, allow us to demonstrate the

necessary and sufficient conditions for corporate turnaround with varying levels of debt and equity finance in the absence and presence of a MCC.

In terms of research methodology, we use a quantitative and qualitative historical analysis, since “organizations are complex, variable-rich phenomena that can be studied from multiple perspectives” (Daft and Lewin, 1990, p.2). Following other quantitative and qualitative studies on business turnaround, we used a combination of case analysis of individual firms (e.g., Ruiz-Navarro, 1998), and analyses of published accounts of from different periods by experts, business writers, public press, etc (see Bruton, et al., 1994; 2003; for a similar research methodology). In addition, we conducted a detailed analysis of published financial data for sub-samples of firms at different stages of the industry life-cycle. This approach allows us to develop a longitudinal study across several organizations which is essential when one analyses complex and dynamic interrelationships between finance, organisational processes and strategy (Daft and Lewin, 1990; Lee, 1999). Cross sectional multiple industry content studies are inadequate for capturing these sequential patterns and for the assessment of under-researched process aspects of turnarounds (Chowdhury, 2002). Another specific advantage of the longitudinal approach as distinct from studies focusing only on the present time is that governance mechanisms, laws and capital markets can be explored as variables of interest as they change through time. In particular, the presence or absence of a MCC can be contrasted with the effects of (de)regulation, capital availability, workforce education level and socio-economic stability on asset restructuring.

The 1920s: A turnaround failure

In 1920 the British cotton textile industry enjoyed a post war boom. Many firms recapitalized, selling equity to financial syndicates and investment groups (Thomas, 1978, p.156). These

changes took place in a highly unregulated environment. The industry was highly competitive, made up of small, specialized firms, employing well-trained and educated workers (Fowler, 2003; Higgins and Toms, 2003). Within a year, the boom, along with export orders collapsed (Burnett-Hurst, 1932; Dupree, 1996, pp.270-71; 283-90). Figure 3 illustrates the extent of the boom and subsequent slump in terms of average company profitability. According to the Robbins and Pearce (1992) model the first response should have been at least cost reduction, and given the severity of the crisis, asset reduction. Neither of these responses materialized, although as the crisis lengthened they became increasingly important.

Figure 3 about here

The discussion that follows differentiates between industry level and individual firm strategies, and a short note is required to explain the interactions between managerial behaviour in both contexts. Because the individual firms were highly specialized, there were limited opportunities for downscoping within the product range, although downsizing the scale of operation was possible. Through associations of manufacturers, strategies were also determined at industry level, one example being the collective action taken to organize short-time working as a response to the over-capacity problem. The result was to sustain the weaker firms and to share reduced output over the same fixed cost base (Keynes, 1981, p.582). Downsizing at firm level was therefore on the basis of a capacity sharing exercise at industry level. As the ensuing discussion demonstrates, the model in figure 1 works reasonably well whether applied to industry or firm level, and in the general case, it must be stressed, these somewhat unusual firm and industry interactions may not be present at all.

The main reason for the failure of the industry to restructure was the impact of governance-based exit barriers. Specifically these barriers were associated with the presence

of outside financial syndicates, which had invested in the industry during the recapitalization boom. To explore this further, we collected financial and economic data that was available for 147 firms from the spinning sector for the period 1926-1931. These data show that where firms had recapitalized, and thus where the impact of outside investors was greater, the attrition rate of firms was lower and the rate of dividend payment higher. Out of a total of 70 recapitalized firms, 57 (81.4%) adopted continuation steady state strategies during the period compared with 57 out of 77 (74.0%) non-recapitalized firms. These steady state strategies typically involved fierce price competition for the available contracts on the basis of covering marginal cost (*Economist*, 9 December, 1922, p.1076). From the point of view of the industry a necessary condition for turnaround was the exit of some firms as a solution to over-capacity problems (Keynes, 1981, pp.583-4, 591) and that was the strategy chosen by the residual firms. A further necessary condition was retrenchment of the existing cost base and reinvestment in new equipment so that unit costs could be reduced and overseas competitiveness restored. However the effect of the governance constraint, which again was pronounced in the recapitalized firms was to ensure that cash secured from contracts was paid out as dividends. The mean dividend rate for recapitalized firms was 5.8% compared with 1.6% for non-recapitalized. In summary, governance factors prevented industry turnaround by constraining exit and prevented firm level turnaround by reducing cash available for reinvestment thereby preventing entry into the recovery stage.

The presence of debt also tended to reduce the probability of turnaround success. In the sample of spinning firms referred to above, high debt was associated with liquidations and complete exit from the industry. The debt to total capital ratio for liquidated firms was 43.6% compared with 34.8% for the surviving firms, illustrating the role of debt as a constraint on turnaround for individual firms. At industry level, in market value terms leverage ratio for all firms was made infinitely worse by the rise in bank debt to finance working capital and

trading losses and collapsing share values (Higgins and Toms, 2003).⁹ Keynes (1981, p.584) refers to 200 mills on an unsound financial basis for this reason.

Although there were important differential effects of governance factors, different groups of shareholders and debt holders faced basically the same decision, which involved comparing expected profits from existing operations with the profitability of the retrenchment strategy.¹⁰ Putting aside some expectations that the downturn was cyclical and temporary, even low profit expectations from continuation were preferable to the alternative. Asset write-downs would entail a re-ordering of financial claims to the detriment of the new investors who had bought in the recapitalization boom. Asset disposals at other than scrap value were prevented by the collapse of the second hand machinery market (Bowker, 1928). Collapsing export markets created spare capacity, whilst new technical advances in spinning and weaving processes rendered deployed assets increasingly obsolete (Ryan, 1930). Because there was no liquid share market and there was no functioning market for corporate control, decision-making on retrenchment and capital redeployment remained in the hands of individual investors (Higgins and Toms, 2003). Labour markets were not a significant constraint and firms were able to impose short-time working on the basis of industry wide agreements (Bowden and Higgins, 1998). Investors chose rationally according to figure 1 to accept marginal profitability on their sunk investments in preference to the almost total loss of capital that would arise from exit. The result was paralysis, and subsequent stage strategic options that ought to have opened up in the Robbins and Pearce model failed to materialize. A crucial remaining question is that since the exit option was closed, why did firms not consider other strategic alternatives?

Figure 1 suggests a comparison of the expected returns from deployed assets against those from the purchase of new assets. Newer and more efficient machinery was available (Board of Trade, 1932, p.135) that would have assisted firms seeking marginal contracts and

the option to undercut competitors. However there were several objections to this strategy. As we have seen above, as profits became available in successful companies, investors were quick to demand dividends as a means of liquidating their previously sunk and at risk investments. The most obvious objection from the investors' point of view was that having lost capital already, this would be throwing good money after bad. A further consideration was that newer machinery was under patent protection, more efficient and therefore more expensive (Joshi, 1935, Sandberg, 1974). To deploy these machines efficiently required integration of spinning, intermediate processes and weaving (Higgins and Toms, 2003), effectively the complete reorganization of vertically specialized factory buildings or the construction of new ones. Taken together this strategy amounted to heavy commitment to high fixed cost assets in conditions of uncertain demand. In addition to cash flow from current operations and the proceeds of asset sales from the disposal of old capacity, it is likely that new financial sources would be required to sustain these investments. As has been shown, none of these sources of funding were available.

Ultimately crisis conditions and the failure of individual firm responses prompted outside intervention. To save the banks from bad loans and financial collapse the Bank of England intervened to close cotton firms down (Bamberg, 1988). This was not the first or last occasion of government intervention in lieu of strategic action by industry participants and where such interventions are necessary there may be further examples of strategic paralysis and turnaround failure.

Post 1960: A turnaround success

By the mid 1980s, Britain's textile industry was reportedly better managed, more resilient and far more competitive than it had been for decades (Van de Vliet, 1988). Such a recovery was

remarkable in the context of the steady decline of textiles spanning back to 1920 and the loss of markets to cheap labour based competition (Singleton, 1991). The interesting question from the perspective of figure 1, therefore, is what had changed since the paralysis of the inter-war period?

There were two important and related changes. First, a combination of Bank of England imposed financial restructuring in the 1930s and profitable contracts during wartime allowed the surviving companies to rid their balance sheets of debt finance. Second, starting from the abortive ICI Courtaulds takeover bid in 1961, a liquid market for corporate control began to emerge. In terms of figure 1, the 1950s to a certain extent mirrored conditions of the 1920s. Claims of the equity owners were based on obsolete assets with low realizable values, whilst replacement costs for new machines continued to escalate. In the 1950s, an illiquid share market promoted the strategy of continued use of existing assets, again exacerbating problems of over-capacity after the post-war boom collapsed in 1952, producing a new slump in corporate performance (figure 3). Although limited exit was promoted when larger firms' capital was used to buy out shareholders at a price below asset book value but higher than realizable value (for detailed examples, see Filatotchev and Toms, 2003), these rationalisation attempts were rare. Instead, to secure survival, firms opted for political lobbying and subsidy, capacity sharing arrangements and price fixing deals. Price fixing was operated through the Yarn Spinners' Agreement. Its abolition through legislation in 1958 accelerated the rationalisation of the industry along with the subsidy scheme of the Cotton Industry Act 1959 (Higgins and Toms, 2000). The Act provided financial assistance for withdrawal from the industry and coincided with the beginning of a series of tariff reductions removing protection from overseas competition in the home market. In the 1960s there was a series of take-over transactions that further and quickly rationalized the industry, resulting in the rapid

concentration of the industry (Hannah, 1979, Rose, 2000), forcing remaining firms to adopt turnaround strategies to ensure survival.

Although there were parallels between 1929 and 1959, in that both witnessed government intervention to enforce capacity reduction and rationalization, there were some very interesting differences with respect to figures 1 and 2. Most crucially, the creation of a market for corporate control meant that turnaround strategies could more easily be carried through. Unlike in the 1920s institutional investors did not demand excessive dividends. From an analysis of the accounting records and share registers for a sample of 45 firms in the period 1959-1970, there was no correlation between institutional shareholding and the rate of dividend payment. We made comparisons between 10 successful turnaround firms (defined as firms that were trading profitably in 1970) and a sample of 10 similar sized firms that failed in the period 1964-1970. The average dividend payment (as a percentage of profit) of the surviving firms was 37.3% compared with 50.3% for failed firms. The successful firms reinvested available profits to fund capital equipment purchases, thereby allowing them to enter the recovery stage. Turnaround successes spent twice as much on capital equipment as a proportion of turnover. In contrast to the 1920s, successful survivors were not prevented by governance constraints from making the reinvestment required in the recovery stage. From an analysis of their share registers, turnaround successes had an average of 27.4% of capital owned by institutions, in contrast to 16.7% for failed firms. These firms also had low debt to total capital ratios (13.0%). Unlike in the 1920s, investor groups were able to envision and accept alternative strategies, including restructuring and reinvestment.

An important reason for the non-application of the dividend constraint in the 1960s, in contrast to the 1920s was the development of a liquid market for corporate control. This also reduced exit barriers and the way paved for industry restructuring. In the 1920s there were no cases of companies being taken over by other companies, whereas in the 1960s a large

number of companies were bought and sold.¹¹ Once purchasers were available, the incentive of incumbent investors to enforce the continued use of old assets strategy was greatly reduced because the market capitalization of the firm provides an alternative basis for the NRV break up value from the investor's point of view. The point is well illustrated by the acquisitions of David Alliance. For example the balance sheet of Rothwell Ltd showed book value net assets of £1,337K in 1962, and Alliance offered £1044K for the shares, in excess of the market capitalization of £783K. Cash consideration was the norm for acquisitions in this period since exiting shareholders enjoyed high earnings yields *vis a vis* acquiring shareholders, for example the acquisitions of Smith and Nephew (Foreman-Peck, 1995). The amalgamations of the early 1960s transformed the British cotton industry into the most concentrated in the world (Rose, 2000, p.287). The motivation for these acquisitions was related diversification from established businesses adjacent to cotton and wishing to control supply. This motive explained Smith and Nephew's acquisition of mills in Brierfield and the Rochdale area in the 1950s, the acquisition of Lancashire Cotton Corporation by Courtaulds and ICI's acquisition of Viyella (Foreman-Peck, 1995, Rose, 2000, Owen, 1999). Product relatedness and associated economies of scope explain why acquiring firms could in many cases offer a price in excess of NRV without destroying value for their own shareholders. Rationalization nonetheless followed acquisition in many cases by the major combines, thereby facilitating the capacity reduction and asset replacement that had been impossible in the 1920s and difficult before 1960. For the first time therefore investment in new machinery as a cost reduction strategy became a realistic option for large sections of the industry.¹² In the companies taken over by David Alliance that ultimately became Coats Viyella, in Courtaulds and in Smith and Nephew, old mills purchased from incumbent shareholders were re-equipped with modern machinery (Ormerod, 1996, Foreman Peck, 1995). Unlike in the inter-war period the important recovery stage component of the turnaround model could be

implemented. Channels of new equity-based financial sources for these projects via City financial networks were utilized (Toms and Filatotchev, 2004) for the first time since the refloating debacle of the 1920s.¹³

Implications

The empirical example shows that linkages in process between the main stages of the Robbins and Pearce, (1992, p.291) model are far from automatic. In the light of the examples it is worth reconsidering this model and extending its scope with reference to figure 1. Perhaps most significant, as demonstrated above, is the requirement to add a re-alignment stage as a precondition for firms entering the retrenchment and recovery stages. However, there are further and subtler extensions, illustrating the potentially problematic preconditions for transition in the remaining stages. In the Robbins and Pearce model, financial problems are addressed at the first retrenchment stage, which aims to stabilize operations and restore profitability by pursuing cost and/or asset reductions. Recall that the expected return in figure 1 and the subsequent realized level of profit reflects the cost base of the firm. Where cost reduction strategies are pursued, the process is facilitated where the cost base of the firm is variable. Where the cost base is fixed, it is more difficult to stabilize cash flow without also altering the strategic basis of activity. To the extent that financial distress is severe and/or strategic health is weak, asset reduction becomes increasingly imperative for turnaround (Hofer, 1980; Pearce and Robbins, 1993). However, as the illustration suggests, the causes of financial distress may also impact on the disposal value of assets. This is very important because the effectiveness of asset reduction strategies as a precursor to subsequent recovery depends substantially on the ability of the firm to generate cash flow from these disposals. Although the literature uniformly presupposes this to be possible, in the empirical illustration

and in the general case there are difficulties arising from asset specificity, liquidity in the second hand market and similar exit barriers.

Special cases may be derived from the model in figure 1, which illustrate the impact of combined factors on turnaround strategies. The first is where asset values impose a hard constraint on exit strategies and prevent constrained firms developing second stage recovery strategies through reinvestment in product/process innovation. The typical economic model assumes no capital rationing (Weingartner, 1977), but capital allocation to an industry depends on governance structures and lending conditions. With very high levels of capitalization, high asset specificity and low resale values in external markets, financial and physical capital supply becomes highly inelastic, or subject to hard rationing. In other words, positive net present value (NPV) projects will be rejected even when the outcome is positive with a high degree of certainty. Where these conditions apply, it is difficult and perhaps even impossible for incumbent management to apply the standard turnaround prescription. In the case of British textiles in the 1920s, sunk investment in old machinery and the attitudes of investors prevented investment in new machinery, even where firms were otherwise returned to profit.

Low resale values for highly specific assets prevent stabilization of cash flow in the retrenchment stage. Nor can overhead costs be reduced, where as in this case they arose from fixed financial claims. Even leaving these problems aside nothing can be done in the recovery stage even if it can be entered, as the positive NPV projects that must now be rejected are the necessary investments in new product and process. In terms of figure 1 parameters this means that however much crisis conditions drive down financial performance, the economic rate of return from the “do nothing” strategy is superior to the loss of capital associated with exit at low resale value. Meanwhile lack of cash flow from such realizations and the hard rationing constraint prevent reinvestment in new products and processes, however profitable they may

be. Financial claim holders will therefore rationally, through the governance structure, impose the “do nothing” strategy on management.

As far as the role of debt finance is concerned, the explanation is similar to Hart and Moore (1995), but the scenario presented here shows the holders of equity in recapitalized assets to be in the same position. It follows from the scenario in the 1920s that although debt compounded the problem, even without debt, outside equity holders can impose similar constraining strategies on management. In terms of figure 2, although debt made the problem worse, in the absence of a market for corporate control the turnaround problem would have been almost as formidable for all equity financed firms. In these circumstances, shareholders will aim to extract any remaining value from assets in use, for example by undercutting competitors to obtain marginal contracts. Such limited strategies may further intensify competition. Where the crisis is generated by a sudden and sustained fall in demand, failure to exit due to the relationships suggested above will accentuate the crisis further by creating over-capacity. These features characterized many staple industries in the UK and other industrialized economies in the 1920s and 1930s. By the 1960s, although the underlying causes of industry decline remained, turnaround at the level of the individual firm was made possible by the evolution of the market for corporate control, a mechanism not available to the politicians and industrialists responding to the slump conditions of the inter-war period.¹⁴

DISCUSSION AND CONCLUSIONS

Some turnaround researchers suggest that retrenchment strategies involving the sale of critical assets might be detrimental as a result of trading short run survival for longer run strategic advantage (Barker and Mone, 1994). The ultimate objective of retrenchment is to improve organizational efficiency and increase performance relative to the environment, but results from

the few empirical studies in this area are mixed so far (Bowman et al., 1999, p. 45). Moreover, a number of studies indicate that across-the-board layoffs and ultimately the relinquishing of market share may produce performance trade-offs resulting from the loss of critical employees, lower employee commitment and morale (see, for example, Hoskisson and Hitt, 1994).

The model presented in this paper suggests a more complex story. First, re-alignment of expectations is required so that principals see the opportunities in terms of revised expected returns arising from agents' proposed turnaround strategies. Retrenchment remains an integral part of the turnaround process for the reasons suggested by Robbins and Pearce (1992), but realignment is a precondition and governance constraints may therefore prevent the retrenchment stage being entered. Second and closely linked, the paper has illustrated that asset sales are not always discretionary and governance arrangements may prevent such disposals, particularly where outside investors favour their continued use as a means of fulfilling dividend expectations. As the case above illustrates the problem is acute in specialized firms, but may be less likely in multi-product firms where managers are more likely to be able to re-deploy resources from one sector to another. More generally, it is easy to see how such problems are mitigated by the existence of a market for corporate control, but without establishing a precise linkage between the existence of such markets and the efficient deployment of assets. For example, as mentioned above, the market for corporate control may push managers into downsizing the firm in an inappropriate or harmful fashion (Hoskisson and Hitt, 1994). Even so, any advantages of strategic flexibility arising from the functioning of the market for corporate control are only precisely apparent where managers avoid investment in highly specific assets with associated high levels of fixed cost. Investments in such assets, which have entry barrier characteristics associated with difficulty of replication by competitors, are the *sine qua non* of superior performance according to the SFM theory. In short, firms cannot have their cake and eat it. They either commit themselves to high fixed

cost sunk investments paying the price in the event of a crisis, or they avoid them and thereby avoid crisis, but instead fail to achieve competitive advantage and only receive the normal profit levels at the given stage of the business cycle.

Another important implication is that the development of the market for corporate control is closely related to industry development and therefore more general economic development where such development depends at least in part on asset restructuring. Other socio-economic factors often associated with restructuring, such as capital availability via a functioning stock market and banking system, an educated workforce and a deregulated economic framework can all be present, as the case illustrates, but are nullified without a functioning market for corporate control.

Although our research uses historical empirical evidence, this paper has important implications for more contemporary research on business turnaround, especially in countries that do not have developed and liquid stock markets, such as transition and developing economies. For example, in their study of retrenchment and downsizing strategies in transition countries, Filatotchev et al. (2000) show that in the absence of a market for corporate control, privatization programmes resulted in insider ownership and a consequent failure of ailing, formerly state-owned enterprises to restructure and modernize. In addition, research on the roles of banks in transition economies suggests that over-exposure of financial institutions to loans to inefficient enterprises created a “systemic failure” when banks impose financial constraints on restructuring and closure enterprise of heavily indebted failing firms (Saunders and Sommariva, 1993). The study therefore complements others, which have examined international variations in institutional contexts. Generalization is limited due to such variation, although one with important implications for asset restructuring in developing countries is the relationship between increased market governance and efficient resource allocation (Hoskisson et al, 2004, p.527).

To conclude, the paper has shown that a complete theory of turnaround requires researchers to incorporate asset valuations as part of their analysis and show how such valuations influence the selection of strategic options, impose constraints on managerial action, and motivate their principals to enable or restrict the implementation of such options. To understand these complex dynamics, researchers should examine the precise options available to managers through auditing imperfections in the firm's strategic factor markets, including particularly financial markets and the market for corporate control. In general they should develop longitudinal frameworks encompassing industry life-cycles that relate firm strategic dynamics to the valuation of strategic factor inputs and to structures of corporate governance.

REFERENCES

- Aghion, P., and Bolton, P. (1992). 'An incomplete contract approach to financial contracting'. *Review of Economic Studies*, **59**, 473-494.
- Altman, E. (1984). 'A further empirical examination of the bankruptcy cost question'. *Journal of Finance*, **39**, 1067-1089.
- Armour, J., and Frisby, S. (2001). 'Rethinking Receivership'. *Oxford Journal of Legal Studies*, **21**, 73-102.
- Arthur, W. B. (1989). 'Competing technologies, increasing returns, and lock-in by historical events'. *The Economic Journal*, **99**, 116-131.
- Bamberg, J.H. (1988). 'The rationalization of the British cotton industry in the inter-war years'. *Textile History*, **19**, 83-102.
- Barker, V.L., and Duhaime, I.M. (1997). 'Strategic change in the turnaround process: Theory and empirical evidence'. *Strategic Management Journal*, **18**, 13-38.
- Barker, V. L. and Mone M. A. (1994). 'Retrenchment: Cause of turnaround or consequence of decline'. *Strategic Management Journal*, **15**, 395-405.
- Barney, J. B. (1986). 'Strategic factor markets: Expectations, luck and business strategy'. *Management Science*, **32**, 1231-41.
- Bethel, J.E., and Liebeskind, J. (1993). 'The effects of ownership structure on corporate restructuring'. *Strategic Management Journal*, **14**, (special issue), 15-31.
- Bibeault, D. B. (1982). *Corporate Turnaround: How Managers Turn Losers into Winners*. McGraw-Hill, New York.
- Board of Trade, (1932). *An Industrial Survey of the Lancashire Area (Excluding Merseyside)*. London, H.M.S.O.

- Bowden, S. and Higgins, D.M. (1998) 'Short-time working and price maintenance: Collusive tendencies in the cotton spinning industry, 1919-1939'. *Economic History Review*, **51**, 319-343.
- Bowker, B. (1928). *Lancashire under the Hammer*. London: Hogarth.
- Bowman, E.H., Singh, H., Useem, M., and Bhadury, R. (1999). 'When does restructuring improve economic performance?' *California Management Review*, **41**, 33-54.
- Brickley, J.A., Lease, R.C. and C.W. Smith (1988). 'Ownership structure and voting on antitakeover amendments'. *Journal of Financial Economics*, **20**, 267-291.
- Brown, D. T., James C. M. and Mooradian, R. M. (1993), 'The information content of distressed restructuring involving public and private debt claims'. *Journal of Financial Economics*, **33**, 93-118.
- Bruton, G. D., Oviatt, B. M., and White, M. A. (1994) 'Performance of acquisitions of distressed firms'. *Academy of Management Journal*, **37**, 972-989.
- Bruton, G.D., Ahlstrom, D., Wan, J.C., 2003. 'Turnaround in East Asian firms: evidence from ethnic overseas Chinese communities'. *Strategic Management Journal*, **24**, 519-540.
- Burnett-Hurst, A. (1932) 'Lancashire and the Indian market'. *Journal of the Royal Statistical Society*, **95**, 395-440.
- Cameron, K.S., Kim, M.U., and Whetten, D.A. (1987), 'Organizational effects of decline and turbulence'. *Administrative Science Quarterly*, **32**, 222-240.
- Cameron, K. S., and Whetten, D. A. (1981). 'Perceptions of organization effectiveness across organizational life cycles'. *Administrative Science Quarterly*, **26**, 525-544.
- Castrogiovanni, G. and Bruton, G. (2000). 'Business turnaround process following acquisitions: Reconsidering the role of retrenchment'. *Journal of Business Research*, **4**, 25-34.

- Chowdhury, S. D. (2002). 'Turnarounds: A stage theory perspective'. *Canadian Journal of Administrative Sciences*, **19**, 249-266.
- Citron, D., Wright, M., and Robbie, K. (1997). 'Loan covenants and relationship banking in MBOs'. *Accounting and Business Research*, **27**, 277-294.
- Citron, D., Wright, M., Ball, R., and Rippington, F. (2003). 'Secured creditor recovery rates from management buy-outs in distress'. *European Financial Management*, **9**, 141-161.
- Daft, R.L. and Lewin, A.Y. (1990). 'Can organization studies begin to break out of the normal science straightjacket? An editorial essay', *Organization Science*, **1**, 1-9.
- Daily, C.M. and Dalton, D.R. (1998) 'The role of governance in corporate decline: A review and research agenda' in Foster, L and Ketchen, D. (eds) *Advances in Business Strategy Vol.5. Turnaround Research: Past Accomplishments and Future Challenges*.
- De Witt, R.-L. (1998). 'Firm, industry, and strategic influences on choice of downsizing approach'. *Strategic Management Journal*, **19**, 59-79.
- DeAngelo, H. and DeAngelo, L. (1990). 'Dividend policy and financial distress: An empirical investigation of troubled NYSE firms', *Journal of Finance*, **45**, 1425-1431.
- Doukas, J., and Travlos, N.G. (1988). 'The effect of corporate multinationalism on shareholders' wealth: Evidence from international acquisitions'. *Journal of Finance*, **43**, 1161-1175.
- Dupree, M. (1996). 'Foreign competition and the inter-war period', in M.B.Rose (ed.) *The Lancashire Cotton Industry*, Preston: Lancashire County Books, 265-95.
- Edey, H. (1962). 'Business valuation, goodwill and the super-profit method', in Baxter, W and Davidson, S. (eds.) *Studies in Accounting Theory*, Sweet and Maxwell, London.
- Edwards, E. and Bell, P. (1961). *The Theory and Measurement of Business Income*, University of California Press.

- Edwards, J., Kay, J. and Mayer, C. (1987). *The Economic Analysis of Accounting Profitability*, OUP: Oxford.
- Eisenhardt, K.M. (1998). 'Agency theory: An assessment and review'. *Academy of Management Review*, **14**, 57-74.
- Filatotchev, I., Buck, T., and Zhukov, V. (2000). 'Downsizing in privatized firms in Russia, Ukraine and Belarus'. *Academy of Management Journal*, 2000, **43**, 286-304.
- Filatotchev, I., and Toms, S. (2003). 'Corporate governance, strategy and survival in a declining industry: A study of UK cotton textile companies'. *Journal of Management Studies*, **40**, 895-920.
- Foreman-Peck, J. (1995). *Smith and Nephew in the Health Care Industry*. Aldershot: Edward Elgar.
- Fowler, A. (2003). *Lancashire cotton operatives and work, 1900-1950: A social history of Lancashire cotton operatives in the twentieth century*. Aldershot: Ashgate.
- Franks, J. R. and Tourous, W. N. (1994). 'A comparison of financial recontracting in distressed exchanges and Chapter 11 reorganizations'. *Journal of Financial Economics*, **35**, 349-370.
- Franks, J., and Mayer, C. (1997). 'Corporate ownership and control in the U.K., Germany and France'. *Journal of Applied Corporate Finance*, **9**, 30-45.
- Franks, J., and Sussman, O. (2005). 'Financial distress and bank restructuring of small to medium size UK companies'. *Review of Finance*, forthcoming.
- Gilson, S. C. (1989). 'Management turnover and financial distress'. *Journal of Financial Economics*, **25**, 241-262.
- Grinyer, P. H., Mayes, D. G. and McKiernan, P. (1988). *Sharpbenders: The Secrets of Unleashing Corporate Potential*. Basil Blackwell, Oxford.

- Grinyer, P. H and McKiernan, P. (1990). 'Generating major change in stagnating companies'. *Strategic Management Journal*, **11** (special issue), 131-146.
- Grossman, S., and Hart, O. (1995). 'The costs and benefits of ownership: A theory of vertical and lateral integration'. In *Transaction Cost Economics*, O. Williamson and S. Masten (eds.), Edward Elgar Publishing.
- Hannah, L. (1979) *The Rise of the Corporate Economy*, London: Methuen.
- Hambrick, D. & D'Aveni, R. (1992). 'Top team deterioration as part of the downward spiral of large corporate bankruptcies'. *Management Science*, **38**, 1445-1466.
- Hambrick, D. C. and Schecter, S. M. (1983). 'Turnaround strategies for mature industrial-product business units'. *Academy of Management Journal*, **23**, 231-248.
- Hart, O. (1995). *Firms, Contracts and Financial Structure*. Oxford: Oxford University Press.
- Hart, O., and Moore, J. (1995). Debt and seniority: An analysis of the role of hard claims in constraining management'. *American Economic Review*, **85**, 567-585.
- Higgins D.M and Toms, J.S. (2000). 'Public Subsidy and Private Divestment'. *Business History*. **42**, 59-84.
- Higgins D.M and Toms J.S. (2003). 'Financial distress, corporate borrowing and industrial decline: The Lancashire cotton textile industry, 1918-1938'. *Accounting Business and Financial History*, **13**, 207-232.
- Hitt, M.A., Hoskisson, R.E., Johnson, R.A., and Moesel, D.D. (1996). 'The market for corporate control and firm innovation'. *Academy of Management Journal*, **39**, 1084-1119.
- Hofer, C. W. (1980). 'Turnaround strategies'. *Journal of Business Strategy*, **1**, 19-31.
- Hoskisson, R.E., and Hitt, M.A. (1994). *Downsizing: How to Tame the Diversified Firm*. New York and Oxford: Oxford University Press.

- Hoskisson, R.E., Johnson, R.A., and Moesel, D.D. (1994). 'Corporate divestiture intensity in restructuring firms: Effects of governance, strategy and performance'. *Academy of Management Journal*, **37**, 1207-1251.
- Hoskisson, R.E., Hitt, M.A Johnson, R.A. and Grossman, W. (2002). 'Conflicting voices: The effects of institutional ownership heterogeneity and internal governance on corporate innovation strategies'. *Academy of Management Journal*, **45**, 697-716.
- Hoskisson, R.E, Cannella, A.A., Tihanyi, L. and Faraci, R. (2004). 'Asset restructuring and business group affiliation in French civil law countries'. *Strategic Management Journal*, **25**, 525-539.
- Jensen, M. (1986), 'The agency costs of free cash flow: Corporate finance and takeovers'. *American Economic Review*, **76**, 323-29.
- Jensen, M. (1993) 'The modern industrial revolution, exit and the failure of internal control systems'. *Journal of Finance*, **48**, 831-880.
- John, K., L. Lang, H. P. and Netter, J. (1992). 'The voluntary restructuring of large firms in response to performance decline'. *Journal of Finance*, **47**, 891-917.
- Joshi, B. (1935) *Articles on Preparatory Machines, Cotton Weaving, Yarn Testing etc*, Bombay: Times of India Press.
- Ketchen, D., Snow, C. and Hoover, V. (2004). 'Research on competitive dynamics: Recent accomplishments and future challenges.' *Journal of Management*, **30**, 779-804.
- Keynes, J.M. (1981) *The Return to Gold and Industrial Policy II*. Collected works, Cambridge: Cambridge University Press, 578-637.
- Kim, H. and Hoskisson, R.E. (1996). 'Japanese Governance Systems: A Critical Review.' In Benjamim Prasad (Ed.), *Advances in International Comparative Management*, Greenwich, CT.: JAI, 165-189.

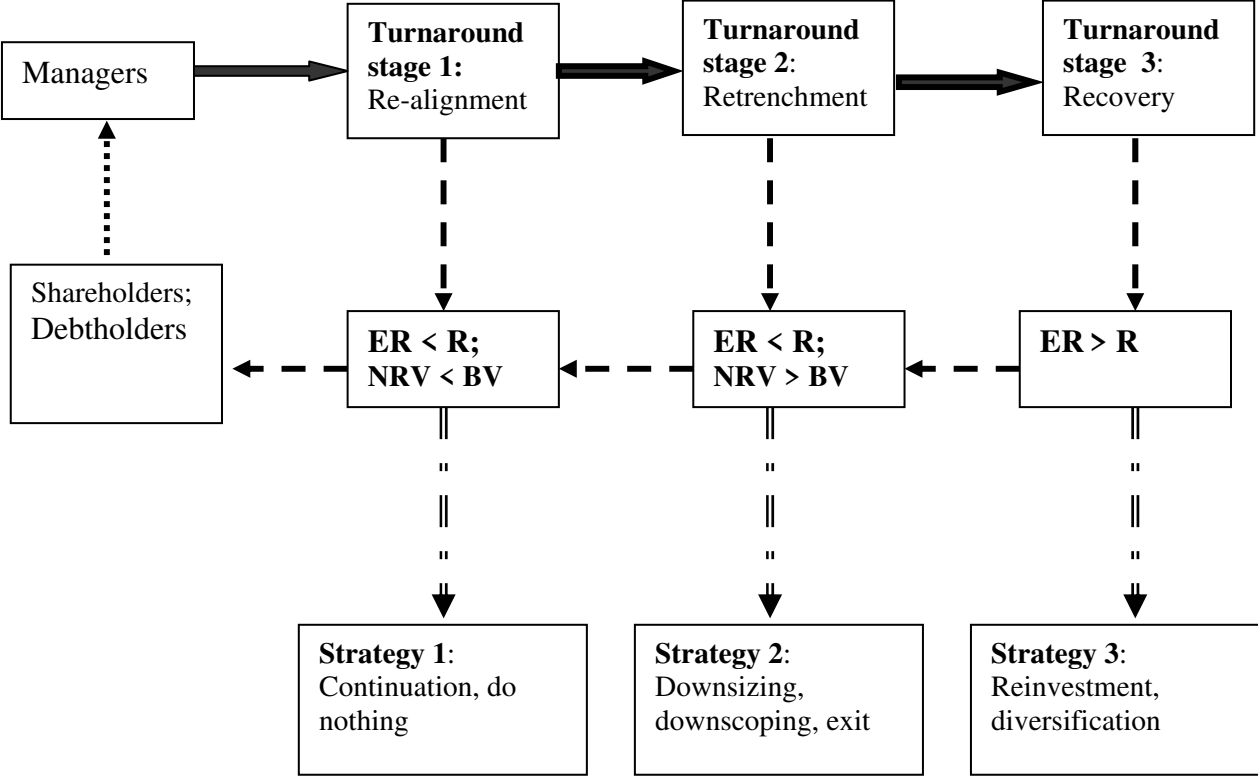
- Kochhar, R. (1996). 'Explaining firm capital structure: the role of agency theory vs. transaction cost economics'. *Strategic Management Journal*, **17**, 713-728.
- Kochhar, R., and David, P. (1996). 'Institutional investors and firm innovation: a test of conflicting hypotheses'. *Strategic Management Journal*, **17**, 73-84.
- Kochhar, R. and Hitt, M. A. (1998). 'Linking corporate strategy to capital structure: diversification strategy, type and source of financing'. *Strategic Management Journal*, **19**, 601-610.
- Kroszner, R., and Strahan, P. (2001). 'Bankers on boards: monitoring, conflicts of interest, and lender liability'. *Journal of Financial Economics*, **62**, 415-452.
- Lee, T.W. (1999). *Using Qualitative Methods in Organizational Research*. Thousand Oaks, CA: Sage Publications.
- Littlewood, J. (1998). *The Stock Market*. London.
- Macrosty, H. (1907). *The Trust Movement in British Industry*. London: Longmans.
- Morrow, J.L., Johnson, R.A. and Busenitz, L.W. (2004). 'The effects of cost and asset retrenchment on firm performance: The overlooked role of a firm's competitive environment'. *Journal of Management*, **30**, 189-208.
- Mueller, D. (1990) *The Dynamics of Company Profits: An International Comparison*. Cambridge, CUP.
- Ormerod, A (1996). *An Industrial Odyssey*, Manchester: Textile Institute.
- Owen, G. (1999). *From Empire to Europe*, London: Harper Collins.
- Pearce, J.A., and Robbins, K.D. (1993) 'Towards improved theory and research on business turnaround'. *Journal of Management*, **19**, 613-636.
- Quinn, R. E., and Cameron, K. (1983). 'Organizational life cycles and shifting criteria of effectiveness: Some preliminary evidence'. *Management Science*, **29**, 33-51.

- Robbins, K.D. and Pearce, J.A (1992). Turnaround: Retrenchment and recovery, *Strategic Management Journal*, **13**, 287-309.
- Ross, J. and Staw, B.M. (1993). Organizational escalation and exit: lessons from the Shoreham nuclear power plant. *Academy of Management Journal*, **36**, 701-732.
- Rose, M. (2000). *Firms, Networks and Business Values: The British and American Cotton Industries Since 1750*. Cambridge: Cambridge University Press.
- Ruiz-Navarro, J. (1998). 'Turnaround and renewal in a Spanish shipyard'. *Long Range Planning*, **31**, 51-60.
- Ryan, J. (1930). 'Machinery replacement in the cotton trade'. *Economic Journal*, **40**, 568-80.
- Sandberg, L. (1974). *Lancashire in Decline*. Columbus: Ohio State University Press.
- Sanders, G. and Carpenter, M. (1998) 'Internationalization and Firm Governance: The Roles of CEO Compensation, Top Team Composition, and Board Structure', *Academy of Management Journal*, **41**, 158-178.
- Saunders, A., and Sommariva, A. (1993). 'Banking sector and restructuring in Eastern Europe'. *Journal of Banking and Finance*, **17**: 931-958.
- Schendel, D., Patton, G. R. and Riggs, J. (1976). 'Corporate turnaround strategies: A study of profit decline and recovery'. *Journal of General Management*, Spring, 3-11.
- Schleifer, A. and Vishny, R. W. (1986). 'Large shareholders and corporate control'. *Journal of Political Economy*, **94**, 461-488.
- Schleifer, A. and Vishny R. W. (1992). 'Liquidation values and debt capacity: A market equilibrium approach'. *Journal of Finance*, **47**, 1343-1366.
- Schmalensee R. and Willig R.D. (eds.) (1989). *Handbook of Industrial Organization*. Vol.2, Amsterdam.

- Schreuder, H. Van Cayseele, P. Jaspers, P. and DeGraff, B. (1991) 'Successful bear-fighting strategies'. *Strategic Management Journal*, **12**, 523-534.
- Schulze, W. S., Lubatkin, M. H., Dino, R. N., and Buchholtz, A. K. (2001), 'Agency Relationships in Family Firms: Theory and Evidence'. *Organization Science*, **12**, 99-116.
- Singleton, J. (1991). *Lancashire on the Scrapheap*. Oxford: Oxford University Press.
- Sirower, M.L. (1997) *The Synergy Trap: How Companies Lose the Acquisition Game*. The Free Press.
- Slatter, S. (1984). *Corporate Recovery: Successful Turnaround Strategies and Their Implementation*. Penguin, Harmondsworth.
- Teece, D. (1980), 'Economies of scope and the scope of the enterprise'. *Journal of Economic Behavior and Organization*, **1**, 223-47
- Thomas, W. (1973). *The Provincial Stock Exchanges*. London: Frank Cass & Co.
- Thornley, T. (1923). *Modern Cotton Economics*. London: Scott Greenwood and Co.
- Tihanyi, L., Johnson, R.A. Hoskisson R.E. and M.A. Hitt, (2003). 'Institutional ownership differences and international diversification: the effects of boards of directors and technological opportunity'. *Academy of Management Journal*, **46**, 195-211.
- Toms S. and Filatochev I. (2004). 'Corporate governance, business strategy and the dynamics of networks: A theoretical model and application to the British cotton industry, 1830-1980'. *Organization Studies*, **25**, 449-472.
- Van de Vliet, A. (1988). 'A ripping yarn'. *Management Today*, August, 41-45.
- Weingartner, H.M. (1977). 'Capital rationing: 'n' authors in search of a plot'. *Journal of Finance*, **32**, 1403-1431.
- Weitzel, W. and Jonsson, E. (1989). 'Decline in organizations: A literature integration and extension'. *Administrative Science Quarterly*, **34**, 91-109.

Whittington R. and Mayer, M. (2000). *The European Corporation*. Oxford: Oxford University Press.

Figure 1: Financial constraints on corporate turnarounds – an analytical model



Key:

- >** Intended strategic change
->** Governance relationships
- - - ->** Profit expectations
- = = =>** Strategic outcome

Abbreviations:
 ER = Expected return
 R = Required rate of return
 RC = Replacement cost
 BV = Book value
 NRV = Net realizable value

Figure 2: Corporate Governance and Turnaround Probability

Market for corporate control	Debt/Equity ratio	Turnaround Success Probability
Yes	Low	High
	High	
No	Low	Low
	High	


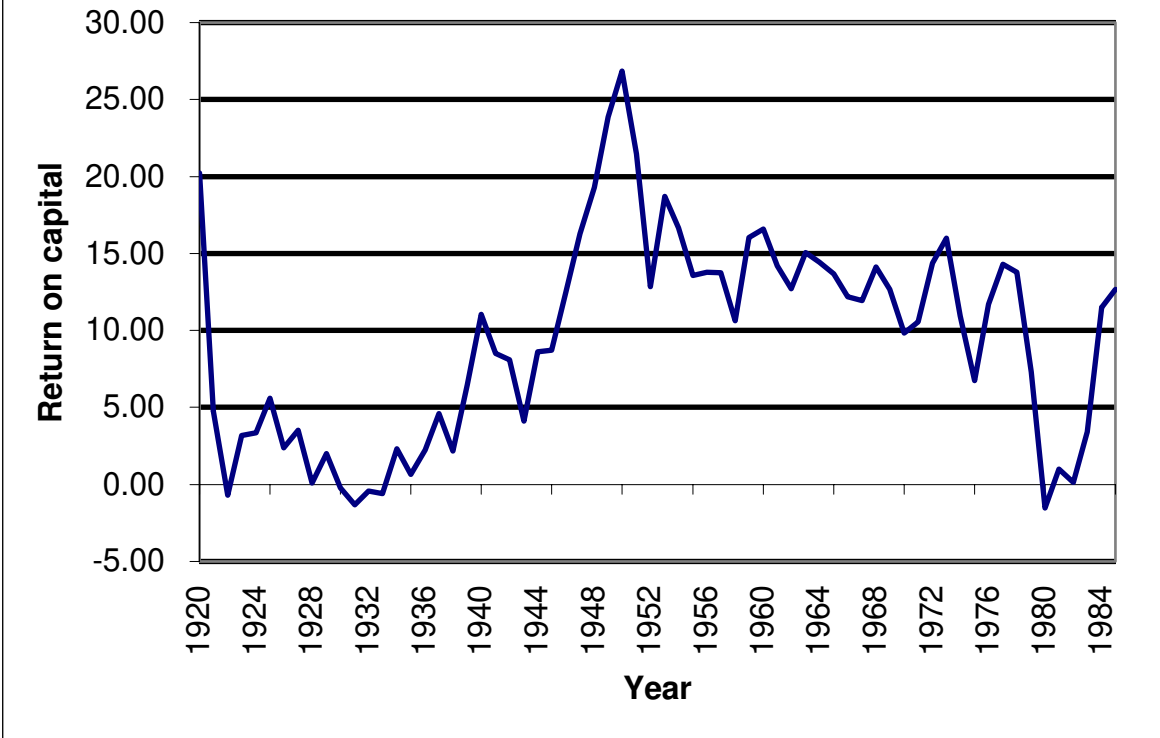


Figure 3: Average Profits in Cotton and Textile Industries, 1920-1985



Note: The data series is collated from accounting data for all quoted firms, in the *Stock Exchange Official Intelligence*, 1920-1948 and on the *Cambridge University Companies Database*, 1949-1985. Return on capital is profit before interest and tax divided by the book value of shareholders' equity plus long term loans.

NOTES

¹ Apart from financial, there may be other constraints on strategic restructuring. For example, in an owner-manager firm, founders or second generation owners-managers may have personal links with the business that would inhibit them from retrenchment and downsizing, and this problem is accentuated by a paucity of alternative employment opportunities (Schulze et al., 2001). This discussion goes beyond the scope of our paper where we focus on relations between external finance providers and hired managers.

² Tihanyi et al. (2003, p.197) acknowledged that the identity of owners has important organizational implications because different owners may have different objectives and expectations. For example, some authors (e.g., Brickley et al., 1988; Kochar and David, 1996) differentiate between “pressure-resistant” and “pressure-sensitive” institutional investors. Pressure-resistant institutions, such as investment funds, are unlikely to have strong business links with their investors, and they may have stronger influence on strategy choices and their performance outcomes (Hoskisson et al., 2002). On the other hand, “pressure-sensitive” investors such as banks are likely to have business relationships with the firms in which they invest (Kroszner and Strahan, 2001). Because they often have an obligation to support the management’s agenda, their governance role tends to be more passive compared to “activist” investors (Tihanyi et al., 2003). However, more detailed analysis of roles and expectations of different owners goes beyond the scope of this paper.

³ In the 1990s such premiums averaged 40%, although it has been shown that if the premium is greater than 25% it is unlikely that the acquiring firm will earn back the premium (Sirower, 1997). Some premiums may be appropriate because of the expected synergy while others are likely to represent overpayments.

⁴In the UK, in the event of bankruptcy control rights pass to the secured creditors. Conditional upon default, they have an exclusive right to decide whether, when and how to seize the company's assets and liquidate them. A designated secured creditor appoints a registered insolvency practitioner, the receiver, to take over all powers of the firm's board, and to make sure that sufficient funds will be realized to repay the debt to the secured creditor. The receiver has no duty to consider interests of other lenders, and has decision-making rights over whether to sell the firm as a going concern or close it and sell it piecemeal (see Franks and Sussman, 2004, for a detailed discussion). Unsecured creditors have few control rights and do not participate in the sale of firm's assets. However, they have some liquidation rights and they can apply for a winding up of the firm by a liquidator. Unlike the receiver, the liquidator operates on behalf of all creditors, but without a power to change the order of seniority (Armour and Frisby, 2001).

⁵ For example, in their study of bank-driven restructuring of small and medium size UK companies, Franks and Sussman (2004) indicate that the concentration of collateral and liquidation rights the hands of the main bank gives it a dominant position in restructuring a defaulting firm. However, they also find that the bank's dominance makes it "lazy" in monitoring, relying heavily on the value of its collateral in timing bankruptcy decisions. Citron et al. (1997) explore the role of loan covenants in the relationships between banks and management buy-out (MBO) firms. They find evidence of close bank/MBO relationships and bank involvement in effecting turnaround of financially troubled MBOs.

⁶ For example, in their study of 42 failed MBOs Citron et al. (2003) provide evidence that secured creditors recover only 62 percent of the amount owned. However, this percentage

increases where the distressed buy-out is sold as a going concern, which may explain why banks in their study prefer this form of restructuring. Franks and Sussman (2004) report similar recovery rates using a larger sample of financially distressed firms in the UK.

⁷ More recently, banks have endeavoured to avoid liquidations using “corporate recovery” services provided by accountancy firms. However, although this may help banks to recover a higher proportion of their problem loans, “corporate recovery” firms cannot eliminate financial constraints on turnaround strategies of highly leveraged firms.

⁸ This behaviour resembles what Ross and Staw (1993) call “escalating commitment” when explaining how organizations become committed to losing courses of action over time. These authors suggest a number of determinants of escalation that include, in addition to psychological and social factors, such strategic aspects as project closing costs, salvage value, “sunk costs”, etc. A possible impact of these factors on banks’ decisions to provide further finance to failing firms may shed a new light on the limitations of debt-based governance, but this discussion goes beyond the scope of the paper.

⁹ The average leverage ratio for all 147 firms was 37% with a standard deviation of 33%, indicating that many firms were highly levered. If the market value of equity is used instead of book value, the situation for the highly geared firms was much worse. By 1931, many companies experienced collapses in share values, resulting in very low market capitalizations. For example Laurel and Compton spinning companies both had capitalizations of < £5000 but outstanding debt of more than £40000 (source: *Tattersall’s*). There were many similar cases.

¹⁰ Leading accounts of the crisis of the 1920s (Keynes, 1981, Bamberg, 1988) concentrate on the role of the banks and ignore the shareholders. Such emphasis is incorrect, and the shareholders played an important role (Higgins and Toms, 2003). The dynamics of the turnaround model and the coincidence of interest between debt holders and shareholders highlighted in this paper support the re-interpretation of this chapter of economic history.

¹¹ From 1900 there were waves of mergers in textiles (Hannah, 1979). These were voluntary amalgamations and associations, often accompanied by stock market flotation or re-floatation (Macrosty, 1907, Higgins and Toms, 2003). There were no share-for-share bids for control in the open market and hostile bids on such a basis did not occur in this or any other sector until the 1960s (Littlewood, 1998).

¹² This restructuring was undertaken when the firm became part of a larger, vertically integrated combine, and this represents a departure from the original Robbins and Pearce (1992) turnaround model that focuses on strategic choices of an independent firm. However, restructuring strategies involved retrenchment and modernization that are outlined by Robbins and Pearce (1992) framework.

¹³ Evidence on re-equipment at Coats Viyella and utilization of financial networks, particularly nominee accounts held by Rothschilds was taken from an interview transcript with a former senior executive of the company.

¹⁴ There were other legal and regulatory changes that may have had an impact on success or failure of turnaround strategies during the period of study. For example, the UK contractualist approach to bankruptcy and liquidation has changed since its formative years in the late 19th

century from not imposing any constraints on the contract to the accumulation of a body of case law that has standardised particular lending instruments (Franks and Sussman, 2004). Court-administered *Administration* and *Company Voluntary Arrangements* procedures of the more recent Insolvency Act further even out the allocation of rights in bankruptcy across the secured and unsecured lenders and provide the company with temporary protection from creditors' actions. However important they may be, these legal developments do not change the main arguments of this paper. Similarly, Note 1 above emphasises possible impacts of family control on business strategy. Because hardly any new textile firms were founded after 1920 but the attrition rate was slow during the protracted subsequent decline (Rose 2000, Higgins and Toms, 2003), it is reasonable to suppose that the proportion of family firms to publicly quoted remained approximately constant.